Supreme Court, U. S.
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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1979.

No. 79-725

THE STATE OF MAINE
PUBLIC UTILITIES COMMISSION,
PETITIONER,

v.

CENTRAL MAINE POWER COMPANY,
RESPONDENT.

Petition for a Writ of Certiorari to the Supreme Judicial Court of the State of Maine.

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v.

CENTRAL MAINE POWER COMPANY,
RESPONDENT.

Petition for a Writ of Certiorari to the Supreme Judicial Court of the State of Maine.

The petitioner Maine Public Utilities Commission respectfully prays that a Writ of Certiorari issue to review a final judgment of the Maine Supreme Judicial Court overruling a ratemaking order of the Maine Public Utilities Commission.

Opinions Below.

The opinion of the Maine Supreme Judicial Court, not yet reported, appears in Appendix A hereto. The opinion and order of the Maine Public Utilities Commission, reported in 26 P.U.R. 4th 388, appears in Appendix B hereto.

Jurisdiction.

The judgment of the Maine Supreme Judicial Court, the highest court in the State in which a decision can be had, was entered on August 6, 1979. This petition was filed within ninety (90) days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3).

Questions Presented.

1. Whether the Maine Public Utilities Commission's adjustment of a public utility's book depreciation expense to account for plant financed by its deferred tax reserve is inconsistent with the normalization requirements of § 167(*l*) of the Internal Revenue Code.
2. Whether § 167(*l*) of the Internal Revenue Code, which prescribes a normalization method of accounting to be used by a public utility that uses accelerated depreciation, requires that a state regulatory agency's treatment of accelerated depreciation for ratemaking purposes be consistent with that method of accounting.

Statutes and Regulation Involved.

The applicable provisions are too lengthy to be set forth in full herein. They are § 167(*l*) of the Internal Revenue Code of 1954, as amended, 26 U.S.C. § 167(*l*), and the Treasury Regulations promulgated pursuant thereto, 26 C.F.R. § 1.167(l). Both the Code provisions and the regulations are set forth in Appendix C hereto. Me. Rev. Stat. tit. 35, § 51 is set out as Appendix D hereto.

Statement of the Case.

A. Introduction.

This petition challenges the validity of a decision of the Maine Supreme Judicial Court that reversed a decision by the Maine Public Utilities Commission (hereinafter "the Commission") to reduce Central Maine Power Company's (hereinafter "CMP") revenue requirements by reducing its depreciation expense to eliminate depreciation on plant financed by deferred taxes. The petition presents a fundamental issue concerning the ability of state regulatory agencies to establish rates that accurately reflect the actual tax expenses of the utilities they regulate, as well as a narrower, but equally important, issue concerning the validity of the Maine Supreme Court's interpretation of § 167(*l*) of the Internal Revenue Code (hereinafter "167(*l*)").

In establishing utility rates, the Commission allows a utility to recover from the ratepayer only those expenses that the Commission deems just and reasonable in accordance with Me. Rev. Stat. tit. 35, § 51. The issues presented for review arise from CMP's practice of "normalizing" certain federal tax expenses in its regulated books of account and in establishing cost of service for ratemaking purposes in accordance with the requirements of 167(*l*). Under normalized accounting, tax expenses for a utility using accelerated depreciation are set at a level that reflects what the utility would pay as federal income tax expense if the utility were using straight-line depreciation and, consequently, were paying higher taxes. In fact, its actual taxes are calculated using accelerated depreciation while the utility enters on its books and collects from its ratepayers, tax expenses that are not paid to the federal government. The difference between the higher federal taxes based on straight-line depreciation and

the amount actually paid is accumulated each year in a deferred tax reserve as required by 167(*l*)(3)(G). An attempt by the Commission to "flow through," that is, to calculate the utility's rates on the basis of the taxes it actually pays, was invalidated by the Maine Supreme Judicial Court in *New England Tel. & Tel. Co. v. Public Utilities Commission*, 390 A. 2d 8 (Me. 1978). No such adjustment was made to CMP's operating income.

B. THE COMMISSION'S DECISION.

On January 16, 1978, CMP, an electric utility whose rates are subject to the jurisdiction of the Maine Public Utilities Commission, filed with the Commission a schedule of revised rates and charges for the purpose of increasing its rates. This proceeding was given the Docket Numbers F.C. #2332 and F.C. #2336. The Commission suspended the proposed increase and the matter was set down for hearing. The Commission Staff entered an appearance and at hearing presented a direct case in opposition to CMP's.

At hearing and in its briefs and argument before the Commission, the Staff proposed a reduction in CMP's test year depreciation expense in order to eliminate depreciation on plant financed by deferred taxes, resulting in an overall revenue requirement reduction of $648,000. As noted above, CMP's tax deferral has accumulated because the company computes its federal taxes using the accelerated depreciation, but computes federal tax expense on its books for ratemaking purposes using straight-line depreciation.

The Commission determined, and there was no dispute, that the amount in the deferred tax reserve was non-investor supplied capital, and all parties agreed that CMP should not earn a return *on* that capital (App. B, p. 141). The Commission therefore deducted the reserve from CMP's rate base, an

adjustment not in dispute. The Commission, however, based upon Staff testimony, further reasoned that the utility should not receive any return *of* non-investor supplied capital. The Commission found that by disallowing in rates the depreciation on plant financed by the deferred tax reserve, the ratepayers, not the shareholders, would receive the benefits of the return of non-investor supplied capital (App. B, pp. 141-142). The Commission therefore multiplied the amount of CMP's average test year deferred tax reserve by its composite depreciation rate, yielding a total reduction to CMP's gross revenue requirement of $648,000.

CMP argued that this adjustment would, under the provisions of 167(*l*), endanger its ability to use accelerated depreciation for federal income tax purposes, because the proposed adjustment would effectively create a different "method of depreciation" for tax and ratemaking purposes within the meaning of 167(*l*)(3)(G) and would therefore be inconsistent with the prescribed normalization method of accounting (App. B, p. 142).

The Commission observed, however, that "the proposed adjustment poses no possibility of adverse tax effects" (App. B, p. 142). The Commission concluded that the difference between the amount of property being depreciated for tax purposes, which includes property financed by deferred taxes, and the amount of property being depreciated for ratemaking purposes and in CMP's regulated books of account, which would not include property financed by deferred taxes, did not constitute a different "method of depreciation" within the meaning of 167(*l*)(3)(G). The Commission reasoned that the proposed adjustment was not an adjustment to CMP's tax expense, because it merely adjusted the depreciable basis of every one of CMP's depreciable assets proportionately to account for that portion that had been financed through non-investor supplied capital (App. B, p. 142). The Commission

noted that Treasury Regulations § 1.167(l)-1(a)(2) provided that "... a change in the taxpayer's ... basis for the property is not a change in the method of depreciation ..." (App. B, p. 143). Because the proposed adjustment was, in effect, nothing more than a change in basis, the Commission concluded that it would not, under 167(*l*), cause CMP to lose its right to use accelerated depreciation (*id.*).

C. The Maine Supreme Court Opinion.

CMP appealed the Commission's Decision and Order to the Maine Supreme Court, which characterized the so-called "deferred tax issue" as "one of the principal issues" raised in the appeal (App. A, p. 34). The Court noted that the adjustment was based on the Commission's "contention that plant financed by the deferred tax reserve constitutes 'contributed property,' as to which we have previously affirmed the propriety of disallowing depreciation expense" (App. A, p. 38). The Court, however, reversed the Commission's determination, holding that the Commission's adjustment violated the normalization requirements of 167(*l*).

The Court ruled that 167(*l*) limited CMP to the use of either straight-line method or the accelerated method with normalization (App. A, p. 45). Premising its conclusion upon the assumption that action by a regulatory agency that is inconsistent with the requirements of 167(*l*) will deprive the utility of its right to use accelerated depreciation (App. A, p. 42), the Court held that the Commission's adjustment placed CMP in jeopardy of losing its right to take accelerated depreciation by departing from the normalization requirements of 167(*l*)(3)(G) (App. A, pp. 45, 50, 56). This departure occurred, in the Court's opinion, because the Commission's reduction in book depreciation expense prevents the full amount of deferred income tax produced by normalization from being credited to the deferred tax reserve (App. A, p. 55). The Court remanded the case to the Commission with instructions to permit CMP to file rates designed to produce additional revenues in the amount of the Commission's "erroneous" reduction (App. A, p. 56). On August 22, 1979, the Commission issued Supplemental Order No. 4 in F.C. #2332, allowing the additional revenue.

Reasons for Granting the Writ.

A. The Absence of Determinative Guidance from This Court on the Meaning of § 167(*l*) Weakens the Regulatory Framework Created to Establish Rates for Public Utilities.

The purpose of disallowing depreciation on contributed or non-investor supplied capital is to recognize that the purpose of depreciation is to recover the original investment in property over the life of the property. Where investors do not supply the capital for contributed property there is no reason to allow them to recover any of the investment. The disallowance of depreciation expense, under this rationale, has been generally accepted by commissions and courts, including the Maine Supreme Court, *e.g., Mechanic Falls Water Co. v. Public Utilities Commission*, 381 A. 2d 1080 (Me. 1977). The adjustment in question, however, although consistent with this established practice, was rejected by the Court because of its perceived inconsistency with 167(*l*).

The Commission's adjustment is based on the assumption that the capital contribution be permanent, and not a mere advance or expense deferral. If CMP must eventually return the contributed capital to the contributors, then the capital must be replaced by investors who would then require a return of their capital through depreciation of the property

that was originally financed by the capital contribution. This Court has found that accelerated depreciation does result in permanent tax savings. *Federal Power Commission v. Memphis Light, Gas & Water Division,* 411 U.S. 458, 460 (1973). The evidence in the case before the Maine Commission established the same point (P.U.C. Staff Exhibit 11, pp. 53-54). Yet the Maine Supreme Court concluded that accelerated depreciation merely deferred tax payment, but did not eliminate it (App. A, p. 41).

The inconsistency between the findings of this Court and those of the Maine Court underscores the need for determinative review of the issue by this Court. The provisions of 167(*l*) and the Treasury Regulations implementing it are highly complex and difficult and yet arise in virtually every rate case involving an investor-owned utility. This law has consequently been grappled with, with varying degrees of success, by several courts and commissions, *e.g., City of Los Angeles v. Public Utilities Commission,* 15 Cal. 3d 680, 125 Cal. Rptr. 779, 542 P. 2d 1371 (1975); *City of Akron v. Public Utilities Commission,* 364 N.E. 2d 869 (Ohio, 1977); *New England Tel. & Tel. Co. v. Public Utilities Commission,* 390 A. 2d 8 (Me. 1978); *Pacific Tel. & Tel. Co.,* No. 87838 (Cal. P.U.C., Sept. 13, 1977). The case at hand demonstrates the ease with which state courts and commissions may become lost in the dark wood of 167(*l*) in the absence of determinative guidance from this Court.

The Maine Court acknowledged that the Commission's adjustment did not "directly" affect CMP's tax expense. It concluded, however, that by applying CMP's composite depreciation rate to the deferred tax reserve (which had been accumulated principally because of CMP's use of accelerated depreciation) and reducing depreciation expense by the result thereof, the Commission was indirectly "using accelerated depreciation to compute depreciation expense for rate-

making purposes and straight-line depreciation to compute depreciation for tax purposes" (App. A, p. 41). This conclusion is based upon the erroneous finding that

> Full normalization requires that the *entire* deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account (namely, straight-line), and (b) the accelerated depreciation used on the income tax return, be normalized [App. A, p. 49.] [Emphasis in original.]

The Court therefore held that the Commission violated the normalization requirements of 167(*l*), even though "indirectly."

The intent of this discussion is to demonstrate the dangers that a highly complex federal law presents to established ratemaking principles, a danger evidenced in this instance by judicial refusal to disallow depreciation expense on non-investor supplied capital. The delicate balance between state and federal areas of control is upset when state regulatory authority is constrained by the actions of state courts attempting, unsuccessfully, to come to grips with difficult and highly technical federal legislation.

Virtually all regulatory bodies are authorized to establish rates that are "just and reasonable," *e.g.,* Natural Gas Act, §§ 4-5, 15 U.S.C. § 717c, 717d (1976); Me. Rev. Stat. tit. 35, § 51; 48 N.Y. [PUB. SERV.] Laws (consol.) §§ 65.1, 72. An essential element of this process is the determination of reasonable expenses that the utility has actually incurred in providing service to its customers and the allowance of rates to recover them. *See generally* 1 A. Priest, *Principles of Public Utility Regulation* 45 (1969). The Maine Court's decision, through misapplication of Federal law, frustrates the Commission's efforts to establish a depreciation expense that is informed by its ratemaking experience and expertise and, as a result, improperly circumscribes its duty to establish just

and reasonable rates. The Court's action was grounded upon its perception that the Commission had indirectly achieved a partial flow-through because its adjustment involved a derivative of accelerated depreciation. The Commission believes that this judgment was in error; yet it is an error of the type that finds its echo in the opinions of other courts and commissions.*

The difficulties attending 167(*l*) will, in the absence of an intelligent exegesis by this Court, inhibit courts and commissions that are reluctant to make or sustain any adjustment that appears to intrude into an area enfettered by the degree of confusion that presently surrounds 167(*l*). Until this Court definitively interprets these provisions, this confusion will continue to impede utility regulators in discharging their statutory duties. That impediment ultimately redounds to the disadvantage of the ratepayers, for whose protection the regulatory duty is established. *See Munn v. Illinois,* 94 U.S. 113 (1876).

The Commission does not mean to suggest that determination of the particular issue before the Court is, of itself, unimportant. The Commission is confident that if the Court addresses the issue, it will uphold the Commission's adjustment. The adjustment applied to all utilities in the State of Maine will save ratepayers several million dollars annually, a substantial amount to a state with the small population and low per capita income of Maine. Moreover, if this adjustment, which does not in any way interfere with the Congressional

* The Commission by no means intends to suggest that the Maine Court alone has failed to address adequately the requirements of this law, *e.g., City of Akron v. Public Utilities Commission,* 364 N.E. 2d 869 (Ohio, 1977). For a persuasive analysis that the California Public Utilities Commission has misapplied the requirements of 167(*l*), *see* Warren, *Tax Accounting In Regulated Industries: Limitations on Rate Base Exclusions,* 31 Rutgers L. Rev. 187 (1978).

policies embodied in 167(*l*), were, with the imprimatur of this Court, employed in other states, the total savings could run to the hundreds of millions of dollars. Even without the consideration that review by this Court would eliminate the chilling effect that 167(*l*) presents to state regulation, the potential economic import of the decision is by itself sufficient reason for granting the writ.

Finally, it should be noted that this case is in the reverse posture of that of *Pacific Tel. & Tel. Co. of Cal. v. Public Utilities Commission,* and *General Tel. Co. of Cal. v. Public Utilities Commission,* on which this Court has denied certiorari, — U.S. —, 99 S. Ct. 733, 58 L. Ed. 2d 713 (1978); — U.S. —, 99 S. Ct. 734, 58 L. Ed. 2d 713 (1978). In those cases, this Court's denial of the petitions perpetuates a regulatory adjustment, despite its possible, but as yet unresolved, conflict with 167(*l*). Although the California Commission, in these cases, may have been incorrect in its adjustment, its regulatory judgment remains undisturbed. In the present case, however, the Maine Commission's judgment has been reversed and the federal issue has directly obstructed the regulatory processes of the Commission.

This case, therefore, presents for this Court the opportunity to provide substantial guidance of lower reviewing courts and regulatory bodies on the requirements of 167(*l*) by definitively interpreting the normalization requirements of that law. Without this guidance by the Court, the complexity and technicality of these requirements will potentiate the unfounded inhibitions that existing regulatory and judicial construction of 167(*l*) has placed upon the duties of regulatory bodies.

B. THIS CASE PROVIDES AN OPPORTUNITY FOR THIS COURT TO DETERMINE WHETHER § 167(*l*) CONSTRAINS A STATE REGULATORY AGENCY'S TREATMENT OF ACCELERATED DEPRECIATION.

In order to use a normalization method of accounting, 167(*l*)(3)(G) requires that the "taxpayer" use certain methods of depreciation. The plain language of the statute, then, refers to the duty of the taxpayer utility, not to the duty of the Commission in fixing just and reasonable rates.* The plain language of a statute, when sufficiently clear, is conclusive as to its purpose. *United States v. Oregon,* 366 U.S. 643 (1961). Thus, the statute of its own force should compel the conclusion that the option to use accelerated depreciation is conditioned upon the method of accounting used by the taxpayer utility, not upon the ratemaking treatment used by a state regulatory agency. The Maine Court, however, concluded that 167(*l*) does regulate the Commission's ratemaking methodology (App. A, pp. 48-49).

The Commission believes that this conclusion is wrong. In addition to the plain language of the statute, the Commission's interpretation is supported by Treasury Regulation § 1.167(l)-1(h)(5), which requires that the taxpayer utility file an amended return *only* when the regulatory body orders a change in the normalized method of accounting, but not when the regulator issues a rate order inconsistent with that method. If 167(*l*) applied to rate orders of the Commission, there would be no reason to exempt rate orders inconsistent with normalized accounting from the amended return requirement.

* Section 46(f)(1) of the Internal Revenue Code, dealing with the investment tax credit for public utilities, does expressly refer to ratemaking actions by regulatory agencies, as well as the taxpayer. Congress is therefore capable of expressly conditioning the availability of tax benefits upon the actions of regulatory agencies, if it wishes to do so.

Moreover, the statutory history of 167(*l*), although conflicting, supports the Commission's interpretation. *See* Hearings on H.R. 6659, House Committee on Ways and Means, 3850-54, 3887, 3592-93, 91st Cong. (1969). As originally drafted, 167(*l*) explicitly restricted the ratemaking methods of regulatory agencies. Chairman Mills concluded that Congress lacked the authority to restrict state ratemaking powers in the manner then proposed (H.R. 6659, 3887). In response to this concern, the principal architect of the bill suggested that it be changed to apply only to the taxpayer's method of accounting, not to a regulatory agency's ratemaking treatment (*id.* at 3850-54). This version of the bill was finally adopted.

Finally, it should be noted that the Commission's interpretation that 167(*l*) applies to the taxpayer only is consistent with the well-established principle that a ratemaking agency has a duty to allow for ratemaking purposes only the amount of taxes actually paid, *e.g., Federal Power Commission v. United Gas Pipe Line Co.,* 386 U.S. 237, 245 (1967).

If this Court were to conclude that the Commission's adjustment is inconsistent with the normalization requirements of 167(*l*), it would of necessity have to determine whether ratemaking adjustments by a state regulatory agency violate the normalization requirements of 167(*l*) and deprive the utility of the option to use accelerated depreciation. The importance of this decision cannot be overemphasized. In 1976, the deferred tax excess for the 100 largest investor-owned electric utilities alone was over two billion dollars, while the actual tax bills of these utilities were only 37.4 million dollars. Environmental Action Foundation, *Utility Scorecard,* 16 (1978). In other words, normalized accounting permitted the 100 largest electric utilities to collect from ratepayers 1.6 bil-

lion dollars in fictitious taxes. If the Commission's position on this issue is sustained by this Court, state regulators would once again have the option of determining whether these tax benefits should continue to be normalized or flowed through to ratepayers.

In *Federal Power Commission v. Memphis Light, Gas & Water Division,* 411 U.S. 458 (1973), this Court, *in dicta,* suggested that 167(*l*) restricted the discretion of the Federal Power Commission in determining which depreciation methods should be used by the F.P.C. for ratemaking purposes. Unlike the F.P.C., however, state regulatory agencies are not creatures of Congressional will and this Court, if squarely presented with the issue, should require a clearer demonstration of Congressional intent to bind state regulatory agencies than is manifested in 167(*l*).

This case presents the Court with an opportunity to decide this issue expressly. If the Court agrees with the Commission on this issue, its decision, in economic impact alone, would be the most important public utilities case decided by the Court in the past decade.

Conclusion.

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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Appendix A.

Date Opinion Filed:
August 6, 1979

Reporter of Decisions
Decision No. 2129
Law Docket No. Ken-78-52

CENTRAL MAINE POWER CO.

v.

PUBLIC UTILITIES COMMISSION, et al.

POMEROY, J.

On January 16, 1978, Central Maine Power Company,[1] pursuant to 35 M.R.S.A. § 64, filed with the Public Utilities Commission[2] a revised schedule of rates and certain revised rules and regulations to become effective on February 15, 1978. This filing operated as a proposal to increase rates to its customers. If effective, revenues would be increased by 12.5% or $24,700,000 annually.

Pursuant to 35 M.R.S.A. § 69 the Commission, by Order dated February 13, 1978, suspended the proposed rates for a period of three months from February 15, 1978, in order to conduct public hearings. On May 12, 1978, the Commission entered *"Suspension Order No. 2"* suspending the filed schedules for an additional five-month period from May 15, 1978.

On January 26, 1978 the Commission began processing the schedules, and, pursuant to Commission order, direct testimony was pre-filed by CMP, the Commission Staff, and various intervenors. At a March 14, 1978 Pre-hearing Con-

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[1] Hereinafter sometimes referred to as CMP, Central Maine, or the Company.

[2] Hereinafter sometimes referred to as the Commission, or the PUC.

ference petitions to intervene and other procedural matters were presented. Ten such petitions were granted by Order of March 17, 1978. Four of those intervenors have participated in this appeal: St. Regis Paper Company, the Consumer Coalition,[3] Maine Oil Dealers Association (MODA) and ten individual complainants, and the Natural Resources Council of Maine.[4] The reaction of Central Maine to the participation of MODA presents special issues.

On February 9, 1978 MODA and ten individuals, all oil dealers and customers of CMP, filed a complaint with the Commission against CMP's rates filed on January 16, 1978 in Docket F.C. #2332. Jurisdiction was alleged under 35 M.R.S.A. § 291. The MODA complaint was docketed as F.C. #2336. CMP filed an answer and motion to dismiss the complaint on February 28, 1978. MODA moved on March 7, 1978 to consolidate its complaint (F.C. #2336) with the pending rate proceeding (F.C. #2332).

By its March 17, 1978 Order the Commission denied CMP's motion to dismiss the MODA complaint and granted MODA's motion to consolidate. MODA's petition to intervene in the pending rate case was also granted. Central Maine thereupon filed a complaint on April 14, 1978 with the Superior Court requesting injunction and declaratory relief, and relief in the nature of prohibition, alleging jurisdiction under Rule 80B, M.R.Civ.P. The Commission filed a motion to dismiss CMP's

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[3] The Consumer Coalition was referred to as the Reeves Group in the March 17 Order, and consists of Bruce M. Reeves, the Maine Citizens Committee for Utility Rate Reform and the Consumer Action Coalition. Hereinafter they will be referred to as the Consumer Action Coalition, or the Consumer Coalition.

[4] Others granted intervenor status were Martin-Marietta Corporation, Keyes Fibre Company, Scott Paper Company, Common Cause, the China Library Association, *et al.*, and the Maine Municipal Association (with the Town of Farmington and the Town of Litchfield). The Maine Municipal Association and the towns were allowed to withdraw by Order of April 25, 1978.

complaint, as did MODA and the ten individual defendants. CMP moved for summary judgment. Oral arguments were heard on July 3, 1978, and by Order dated July 6 the Presiding Justice granted the motions to dismiss the 80B complaint for lack of jurisdiction. Central Maine filed a Notice of Appeal from this dismissal with this Court on August 4, 1978, which appeal was designated Docket No. Ken-78-42.

After public notice, 26 days of hearings were held in Central Maine's rate case (F.C. #2332), during which time the Company, the Commission Staff, and all intervenors choosing to do so participated in the presentation of direct cases and cross-examination. Twenty-one witnesses introduced some one hundred sixteen exhibits into evidence. Additionally, some ninety-four public participants testified, gave statements, and presented twelve exhibits. A total of some 4,670 pages of testimony was generated. Hearings concluded on August 9, 1978, whereupon briefs were filed and oral argument heard on September 7, 1978. The Commission entered its decision on October 13, 1978 (hereinafter the "*Decree*").

The Decree disallowed the schedule of rates filed by CMP on January 16, 1978 designed to produce approximately 25 million dollars in additional revenues, and substituted approval of a two-step increase to produce additional revenues of $15,528,000. CMP thereupon filed substitute schedules on October 1, 1978 and December 1, 1978 designed to produce additional revenues of $6,276,000 and $9,252,000 respectively. These filings were approved by Commission Supplemental Order Nos. 1 and 2 dated October 31 and December 5, 1978, respectively.

Petitions for rehearing filed by various intervenors were denied by Commission orders dated October 31 and November 16, 1978.

In addition to its complaint pursuant to 35 M.R.S.A. § 305

(the § 305 complaint) filed November 2, 1978 (see *post*), CMP and several intervenors filed appeals pursuant to 35 M.R.S.A. § 303 (the § 303 appeals) on or after November 9, 1978 with respect to the Commission's Decree and Supplemental Orders.[5]

Pursuant to 35 M.R.S.A. § 305, the Company on November 2, 1978, by motion filed with the Acting Chief Justice sought to stay the Commission's Decree and Supplemental Order of October 31, 1978 insofar as they precluded CMP from collecting rate revenues beyond those authorized by that Decree and Order.[6] Following oral argument, the motion was denied by decision and order dated November 10, 1978.

By Procedural Order dated January 15, 1979, this Court consolidated in Law Court Docket No. Ken-78-52 CMP's § 305 complaint, its appeal from the Superior Court dismissal of its Rule 80B complaint (formerly Ken-78-42) and the § 303 appeals taken by CMP and all intervenors from the Commission's Decree and Orders. In addition, the Order established a division of issues for purposes of submission of briefs and appendices. Issues concerning revenue requirements and CMP's Superior Court appeal were designated *"Part 1"* issues, and issues concerning rate design were designated *"Part 2"* issues. By a subsequent Procedural Order, dated April 12, 1979, similar provision was made for a division of issues for presentation at oral argument.

A brief outline of the issues presented by the consolidated appeal, and the position of the parties with respect to each, will be useful at this point.

(1) Central Maine Power Company is:

(a) an appellant with respect to its appeal from the Superior Court order dismissing its rule 80B complaint.

(b) a § 305 plaintiff and a § 303 appellant with respect to Commission action concerning these issues:

(i) denial of its motion to dismiss MODA's complaint under 35 M.R.S.A. § 291, and allowance of MODA's motion to consolidate and petition to intervene. (*"The MODA participation issue"*).

(ii) exclusion from rate base of depreciation expense on plant financed by deferred taxes (*"the deferred tax issue"*).

(iii) reduction of CMP's test year revenue requirements by an amount equal to the discount provided employee and retirees (*"the employee discount issue"*).

(iv) use of a capital structure with a 35% common equity ratio to determine the Company's revenue requirements, in lieu of the Company's *pro forma* ratio of 35.2%. (*"the capital structure issue"*).

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[5] CMP filed a § 303 appeal on November 9 from the Commission's Decree of October 13 and its Supplemental Order No. 1 of October 31; it extended that appeal to embrace Supplemental Order No. 2 of December 5 by notice of appeal on December 12. Notice of appeal dated November 15 from the Commission's Decree and notice of appeal dated December 22 from the Decree and from the Commission's orders of October 31 and December 5 were filed by the Consumer Coalition. St. Regis Paper Company and the Natural Resources Council of Maine, *et al.* filed notices of appeal dated November 21 and 22, 1978 respectively.

[6] CMP sought to collect additional revenues of $889,000 representing the *"Maine jurisdictional"* portion of (a) depreciation expense on plant financed by deferred taxes disallowed by the Commission as a rate expense ($641, 500), and (b) the reduction to the Company's revenue requirements made by the Commission equal to the discount provided CMP employees on their electric service ($247,500). While finding *"a reasonable likelihood"* of Commission error with respect to both these deferred tax and employee discount issues, the order concluded that the Company had failed to demonstrate the prospect of *"irreparable injury"* within the meaning of § 305.

(c) an appellee with respect to the appeals taken by the intervenors, relating principally to issues of rate design (*"Part 2 issues"*), but including the revenue requirement (*"Part 1"*), issue of the Commission treatment of its Land Held for Future Use and associated accounts, raised by the Consumer Coalition.

(2) The Public Utilities Commission is a § 305 defendant with respect to CMP's § 305 complaint, and an appellee with respect to all § 303 appeals presented by CMP and by intervenors.

(3) The Maine Oil Dealers Association and ten individual complainants are appellees with respect to CMP's appeal from the Superior Court dismissal of its Rule 80B complaint, and with respect to issues of the intervention and consolidation ordered by the Commission in the rate case below.

(4) St. Regis Paper Company is a § 303 appellant with respect to the Part 2 (rate design) issue concerning the propriety of the Commission's allocation on a uniform basis to all customer classes of the rate increases permitted by its Supplemental Orders (*"the uniform percentage increase issue"*).

(5) The Consumer Coalition is a § 303 appellant with respect to the Part 1 (revenue requirement) issue concerning the Commission's inclusion in rate base of certain CMP properties held for future use (*"the land held for future use issue"*), and with respect to the Part 2 (rate design) issue of the Commission's approval of a $5.70 residential monthly customer charge (*"the customer charge issue"*). While not a designated § 305 defendant, it submits an argument in support of the Commission's position with respect to the employee discount issue.

(6) The National Resources Council of Maine, *et al.*, is a § 303 appellant with respect to the customer charge issue, and with respect to the Part 2 (rate design) issue of the Commission's rejection of implementation of seasonally-differentiated rates in the residential class (*"the seasonal rate issue"*).

We reach the following conclusions as detailed within:

(1) We sustain CMP's appeal from the Commission's denial of its motion to dismiss MODA's § 291 complaint, and accordingly from the consolidation of that complaint with the pending rate case;

(2) We deny CMP's appeal from the Commission's grant of intervenor status to MODA, finding no abuse of the Commission's discretion;

(3) We deny CMP's appeal from the Superior Court order dismissing its 80B complaint for lack of jurisdiction, finding it moot;

(4) We sustain CMP's appeal with respect to the deferred tax issue and the employee discount issue and remand for appropriate adjustments;

(5) We deny CMP's appeal with respect to the capital structure issue;

(6) We deny the Consumer Coalition's appeal with respect to the Land Held for Future Use issue, finding it not to have been appropriately raised before and considered by the Commission;

(7) We reach no decision on St. Regis Paper Company's appeal with respect to the uniform percentage increase issue, finding that our decisions respecting CMP's revenue requirements necessitate the filing of new schedules, which in turn may moot the issue in any of several respects;

(8) We deny the appeals of the Consumer Coalition and the Natural Resources Council with respect to resi-

dential rate design, i.e., the customer charge and seasonal rate issues, finding the Commission action to have been reasonable and supported by substantial evidence.

I.
MODA PARTICIPATION ISSUES

On February 9, 1978, MODA and ten residential customers of Central Maine filed a complaint with the Commission, allegedly based upon 35 M.R.S.A. § 291, challenging as unjust and discriminatory the proposed rates filed with the Commission by Central Maine Power on January 16, 1978 (*"the CMP rate case"*). The § 291 Complaint was designated Docket F.C. #2336, in contradistinction to the Central Maine Power rate case, Docket F.C. #2332. The § 291 Complaint alleged no jurisdictional basis other than 35 M.R.S.A. § 291. Subsequently, on March 17, 1978, the Commission (a) granted a March 7, 1978 motion by MODA to consolidate its § 291 complaint with the pending rate case, (b) denied a February 28, 1978 CMP motion to dismiss MODA's § 291 complaint, and (c) granted MODA intervenor status in the rate case.

The Commission erred in denying CMP's motion to dismiss the § 291 complaint and in allowing its consolidation with the pending rate case. It did not err in allowing MODA's petition to intervene.

A. The § 291 Complaint and Consolidation

In its Order on Pre-hearing Conference, the Commission concluded, after a brief discussion of the legislative history of 35 M.R.S.A. §§ 69 and 291 and their predecessor provisions, that

> *any 10 persons, firms, corporations, or associations aggrieved may file a complaint against proposed rates of a public utility under Sections 69 and 291. Central Maine Power Company's Motion to Dismiss the Complaint in F.C. #2336 is denied.*

We sustain Central Maine's appeal from the denial of this motion.

Section 291 states in relevant part:

> *Upon written complaint made against any public utility by 10 persons, firms, corporations or associations aggrieved, that any of the rates, tolls, charges or schedules or any joint rate or rates of any public utility are in any respect unreasonable or unjustly discriminatory . . . the Commission, being satisfied that the petitioners are responsible and that a hearing is expedient, shall proceed with or without notice to make an investigation thereof . . .*

It is a universally recognized principle of statutory construction that legislative intent must first be sought in the plain meaning of words used in the statute. *State v. Hussey,* Me., 381 A. 2d 665 (1978). Where the statutory language is plain and unambiguous, there is no occasion for resort to rules of statutory interpretation to seek or impose another meaning. *State v. Millett,* Me., 392 A. 2d 521 (1978).

The plain meaning of § 291 is that a complaint under that section may be filed solely with regard to *existing* rates: the complaint is to be made against rates which *"are in any respect unreasonable,"* by persons *"aggrieved"* by them. Proposed rates are not rates within the meaning of § 291. Though they will become effective if not acted upon by the Commission in a timely fashion, 35 M.R.S.A. § 64, they are initially inchoate, having only potential effect. Like the first bid made at an auction, they are simply the starting point for a process which may yield a far different final result. The

statute does not allow complaints against *"rates"* which *"would be"* unreasonable, but only those which *"are."* A clearer indication that the Legislature intended to refer only to existing and effective rates is difficult to conceive. So, too, it is difficult to believe that ten persons can be *"aggrieved"* by proposed rates, which have no substantive effect. *Compare, Heald v. School Administrative Dist. No. 74,* Me., 387 A. 2d 1 (1978); *Matters of Lappie,* Me., 377 A. 2d 441 (1977).

In addition, § 292, requiring the Commission to set a hearing if, after seven days' notice *"such public utility shall not have removed the cause of complaint . . ."* suggests that the complaint process is intended to provide a vehicle for filing grievances against existing practices. It seems highly unlikely that, if the cause of complaint is the proposed rates, the utility may be expected to withdraw or revise the schedules within seven days. Moreover, the availability of such a mechanism, which *requires* the Commission to hold a hearing, would go far toward rendering the § 69 discretionary hearing process a dead letter.

In our decisions in *New England Tel. & Tel. Co. v. Public Utilities Commission,* Me., 354 A. 2d 753, 757 (1976) and *New England Tel. & Tel. Co. v. Public Utilities Commission,* Me., 362 A. 2d 741, 747-48 (1976) we spoke of the use of § 291 to investigate *"a currently effective rate,"* and *"rates and charges then in effect."* The Commission concedes that in 1913, when the basic structure of our utility regulatory scheme was promulgated, the predecessor of § 291 applied solely to existing rates. It contends, however, that the 1917 enactment of the predecessor of § 69 incorporated by reference the § 291 complaint mechanism with respect to proposed rates.[7]

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[7] It should be noted here that MODA's § 291 complaint did not allege § 69 as a jurisdictional basis, preferring to claim jurisdiction exclusively on the basis of § 291. Since the Commission concedes that § 291 itself applies only to existing rates, we consider the issue indulging in the assumption that an allegation of § 291 jurisdiction incorporates reliance on § 69 as well.

Section 69 refers to a *"complaint"* twice, stating in relevant part:

> *Whenever the Commission receives a notice of any change or changes proposed to be made in any schedule of rates filed with said Commission under the provisions of law, it shall have power at any time before the effective date of such change or changes, either upon complaint or upon its own motion and after reasonable notice, to hold a public hearing and make investigation as to the propriety of such proposed change or changes. At any such hearing . . . the burden of proof to show that such change is reasonable shall be upon the public utility. After such hearing and investigation, the Commission may make such order with reference to any new rate, joint rate, fare, rental, toll, classification, charge, rule, regulation or form of contract or agreement proposed as would be proper in a proceeding initiated upon complaint or upon motion of the Commission in any rate investigation.* (Emphasis added).

In the first sentence, the Commission is said to have the *power,* upon *"complaint"* to hold a public hearing. However, § 292, implementing § 291, *requires* the Commission to hold such a hearing if the cause of the (§ 291) complaint is not timely removed. One suggestion that the first reference to *"complaint"* cannot mean a § 291 complaint must thus be noted. Later in the section, the Commission is empowered, in a § 69 proceeding, to make such order *"as would be proper in a proceeding initiated upon complaint."* Obviously, a § 69 proceeding, cannot be one *"initiated upon complaint"* if that reference is not to be meaningless. The section does not refer to itself.

The only logical construction which may be placed upon these references to *"complaint"* is that the second reference (to *"a proceeding initiated upon complaint"*) is to § 291, the effect of which is to incorporate into § 69 the *order* provisions of § 294 (entered in a § 291 investigation), to be exercised *"[a]fter such* [§ 69] *hearing and investigation."* The first reference to *"complaint,"* authorizing but not requiring a hearing, cannot mean § 291, but must envision simply a request that an investigation be made after the proposed rates have been filed by the utility.[8] Unlike the case of a § 291 complaint, a hearing need not be held though the utility shows no intention of removing the cause for complaint, i.e., the proposed rates. The Commission may simply allow them to take effect, leaving open the § 291 remedy of a complaint against *existing* rates.

Our discussion of the meaning of § 69 in *New England Tel. & Tel. Co. v. Public Utilities Commission,* Me., 354 A. 2d 753 (1976) supports this view. The Commission cites that opinion, 354 A. 2d at 762, n.5 in support of its position, quoting our holding that

> *Essentially, Section 69 is concerned with the power of suspension that Section 69 confers upon the Commission. Its thrust, therefore, is basically to adapt to the suspension power the Commission's investigational and decisional methodology as operative under a Section 291* ("10 persons complaint") *or a Section 296 (Commission's* "own" *motion) proceeding.*

Notably, we held the section to *"adapt"* — rather than *wholly* incorporate — §§ 291 and 296 investigational and decisional methodology. We did, in the same footnote, hold that

> *In this manner Section 69 is really incorporating, by reference, the* "order" *provisions of Section 294 (as the order* "properly" *entered in a Section 291, Section 296 or Section 298 rate investigation) i.e., an order requiring that the utility* "substitute" *for the changed schedule of permanent rates initially placed on file under Section 64 the changed schedule of permanent rates determined by the Commission after investigation, to be just and reasonable.* 354 A. 2d at 762, n.5. (Emphasis added).

We nowhere held § 69 to incorporate, as part of *"investigational and decisional methodology,"* the complaint mechanism of § 291, a conclusion which would have been plainly contrary to statutory language (particularly the second reference to *"complaint"* in § 69) and to the entire statutory scheme.

A § 291 complaint may only be brought with respect to existing rates. The Commission therefore erred in denying CMP's motion to dismiss, and in consolidating the improperly allowed action with the pending rate case.[9] On remand, the Commission is ordered to dismiss MODA's § 291 complaint for lack of jurisdiction.

B. The Rate Case Intervention

On February 17, 1978, MODA, on behalf of itself and as

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[8] We agree with the Commission that the mere filing of rates does not *necessarily* initiate a § 69 proceeding, since the Commission may simply allow them to take effect following the § 64 30-day period. However, such filing is *necessary* (if not sufficient) to initiate a § 69 proceeding, and in that sense it can be said to be initiated by the utility. *New England Tel. & Tel. Co. v. Public Utilities Commission,* Me., 354 A. 2d 753, 761-62 (1976). In any event, it does not follow that *"upon complaint"* in § 69 means *"upon § 291 complaint."* The crucial truth remains that *"proceeding initiated upon complaint"* in that section makes sense only if understood to refer to a § 291 complaint.

[9] One Commissioner dissented from the granting of the motion to consolidate, having also dissented from the grant of intervenor status in the rate case to MODA itself.

representative of its individual ratepayer members, filed with the Commission its petition to intervene in F.C. #2332, the CMP rate case. The petition was granted by a majority of the Commission in its order of March 17, 1978.

The Commission urges that we not reach the merits of this issue, contending that because MODA has not appealed, no live controversy exists for our adjudication.

While we agree that Central Maine has failed to show prejudice resulting from MODA's intervention below, and that we can offer no present remedy should we find error, we nevertheless find the issue justiciable. We consider a claim of an improper grant of intervenor status by the Commission to be

> *a claim of right buttressed by a sufficiently substantial interest to warrant judicial protection . . . assert*[ed] . . . *against a defendant having an adverse interest in contesting it. . . . Jones v. Maine State Highway Commission,* Me., 238 A. 2d 226, 228-29 (1968).

The increase in costs and time which may be prompted by widespread intervention require that the propriety of such grants be reviewable regardless of the presence of the intervenor as a party on appeal. At such stage it is the Commission, not the intervenor, who occupies the status of a defendant possessing an adverse interest, i.e., the protection of its powers to grant intervention on the grounds relied upon and there contested. To deny a right to challenge such decisions would present serious due process questions; we hold such a controversy to be judiciable even absent the party whose intervention is complained of.

Commission Rule 16.1 restricts intervenor status to those *"directly and substantially affected by the proceeding."* In *Central Maine Power Co. v. Maine Public Utilities Commission,* Me., 392 A. 2d 302, 312 (1978) we observed that the Rule constitutes a *"reasonable and in fact a necessary requirement if the Commission is to hear and determine the case before it promptly and effectively."* We held in that case, decided only weeks before the Commission's action complained of here, that MODA had erroneously been granted intervenor status in that rate proceeding. There, however, MODA *"sought intervenor status on the basis, fundamentally, that the rates charged by Central Maine in connection with electric space heating represented unfair competition."* *Id.,* 382 A. 2d at 311. Finding the Commission's basic concern in a rate investigation to be *"the relationship of ratepayer to public utility (and ratepayer to ratepayer where discriminatory tariffs are at issue),"* *Id.* at 312, we concluded:

> *We discern in the rate regulation scheme no legislative intent that the Commission take into account the interests of unrelated third parties who chance to be somewhat in competition with a regulated utility. Id.*

We further observed that MODA made no claim that the interests of ratepayers were insufficiently represented in the proceeding, and concluded that, in reality, *"intervenor status was sought here to guarantee a right of judicial review rather than to make possible the presentation of testimony."* *Id.* at 314.

MODA's participation in these proceedings before the Commission transpired under far different circumstances. No claim of unfair competition was raised; indeed, the petition[10] to intervene gives no hint of competitive motives whatsoever.[11] More importantly, the Commission itself preempted

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[10] The petition was filed on behalf of both MODA, a CMP ratepayer, and on behalf of approximately 150 member ratepayers. Some 98 authorization forms from MODA members were produced in support of the petition.

[11] The petition alleged in part:

> *Further as evidenced in its present filing, the rate of return to CMP from the small general service class is considerably higher than that of residential class (12.93 to 8.36). Petitioner believes*

any surreptitious attempt to evade our holding in the prior *Central Maine* case by granting intervenor status with the qualification that *"the intervention must be limited to participation as ratepayers, and any attempt to introduce evidence which relates solely to the competitive position of the oil dealers will be excluded."* Finally, MODA's *bona fides* is demonstrated by its averment in its petition that no expert witness would testify as to rate structure, but that MODA wished to offer such evidence and to cross-examine witnesses on the issue. While that prediction held true only with respect to the Commission, it was reasonable for the Commission to consider it appropriate, in light of other intervenors presenting expert witnesses primarily representing the interests of other customer classes,[12] to insure a voice for the small general service customers. While a grant of intervenor status was not necessary to allow either testimony or cross-examination, it served to settle the issue early in the proceedings, and perhaps avoid later challenges to MODA's right to cross-examine.[13]

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that the rate of return from the small general service class cannot be supported by evidence of cost of service and also that the delineation by CMP between the residential and small general service class is unjust, unreasonable and not cost related. As a result, Petitioner and its members feel that there exists unjust discrimination between classes and within classes.

[12] For example, both the Consumer Coalition and the Natural Resources Council represented essentially residential constituencies, while St. Regis (as well as other intervenors who have not appealed) represented the larger General Service Transmission (GST) customer class.

[13] Intervenors may testify and cross-examine by right, while "*interested parties*" may be precluded from either within the Commission's discretion, under Commission Rule 16.7. Although, by the same token, both testimonial and cross-examination rights may be granted interested parties, an early determination of such rights obviates disruptive delays which may arise when these matters must be settled on an *ad hoc* basis.

While CMP contends in conclusory terms that MODA paid only lip service to its own general service rate, and focused its case upon residential rates (as to which it is competitor), our inspection of the record does not support an allegation of competitive advocacy.

Rather, MODA's concern with residential rates dovetails precisely with its stated rationale for intervention: to demonstrate costs and return inequities between its own small general service rate and residential rates. Indeed, its interest and position is comparable to that of intervenor St. Regis Paper Company, which sought realignment of customer classes on behalf of the large general service transmission (GST) ratepayers. Like St. Regis, MODA's interest was that of one allegedly prejudiced by a discrimination in favor of residential customers which Central Maine itself recognized and challenged. Presentation of that case necessarily entailed reference to residential rates. We are not prepared to deny the Commission the opportunity to hear a legitimate representative of any customer class merely because the representative may, in some tangential way not presented during the proceeding, be in competition with the utility. *Compare, Cole v. Washington Utilities and Transportation Commission,* 79 Wash. 2d 302, 485 P. 2d 71, 90 P.U.R. 3d 62 (1971). Our holding in the 1978 *Central Maine Power v. Public Utilities Commission* case is not inconsistent;[14] our earlier decision in *Gifford v. Central Maine Power Company,* Me., 217 A. 2d 200 (1966) controls.

In *Gifford* we recognized the right of an oil dealers group to appeal from a Commission decision, where they had established their status as ratepayers, and claimed aggrievement

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[14] In this regard, we note that issues concerning the "*relationship of ratepayer to public utility (and ratepayer to ratepayer[])*" referred to in the immediately preceding *Central Maine* case were presented by MODA's petition.

as such.[15] To deny MODA members the right to intervene on the ground that they are competitors would be to deprive them of a right they enjoy by virtue of their status as ratepayers solely because of a secondary status they possess in an area wholly outside the concern of the Commission.

In its decisions with respect to procedural matters, the Commission assumes a status comparable to a court, bound by both its own rules promulgated pursuant to 35 M.R.S.A. § 3 and by the rules of procedure and evidence applicable to civil actions in the Superior Court, 35 M.R.S.A. § 308, *see also* 35 M.R.S.A. § 299; *Central Maine Power Co. v. Public Utilities Commission, supra,* 382 A. 2d at 313. Accordingly, our review of the Commission's grant of intervention is limited to scrutinizing that action for evidence of an arbitrary or capricious exercise of discretion, the burden of proving which rests with CMP. *In Re O'Donnell's Express,* Me., 260 A. 2d 539 (1970); *W.H. Glover Co. v. Smith,* 126 Me. 397, 400, 138 A. 770, 772 (1927). We are satisfied that the Commission properly allowed MODA to intervene as representative of ratepayers *"directly and substantially affected by the proceeding,"* and properly and effectively limited their participation to issues as to which they possessed a legitimate interest.

We deny Central Maine's appeal as to this issue.

C. The Superior Court Appeal

Central Maine responded to the Commission's denial of its motion to dismiss MODA's § 291 complaint and its consolidation of that complaint with the pending rate case by taking an appeal on April 14, 1978 to the Superior Court, Kennebec County. This interlocutory appeal,[16] in the form of a Rule 80B, Maine Rules of Civil Procedure complaint, sought injunctive relief pursuant to 14 M.R.S.A. § 6051(13) and Rule 65, M.R.Civ.P., declaratory relief pursuant to 14 M.R.S.A. §§ 5951, *et. seq.,* and relief in the nature of prohibition. After hearing the Superior Court dismissed the appeal *"for lack of jurisdiction,"* without further elaboration. Central Maine appeals from this dismissal, alleging that the Superior Court's equitable jurisdiction is not foreclosed by 35 M.R.S.A. §§ 303 or 305 where the claimed error is Commission action in excess of its jurisdiction.

We dismiss this appeal as moot.

As part of its consolidated § 303 appeal from the final decision of the Commission, Central Maine has placed before this Court the substantive issues (of MODA's § 291 complaint and its consolidation with the rate case) raised initially before the Superior Court. We have sustained Central Maine's appeals with respect to that complaint and consolidation, the merits of which were not reached by the Superior Court.

CMP now asks that we reverse the Superior Court's dismissal and hold that jurisdiction existed to entertain the substantive claims of its Rule 80B complaint. As we said recently in *Central Maine Power Company v. Maine Public Utilities Commission, et al.,* Me., 395 A. 2d 414, 434 (1978), *"[w]e do not reach that question because our decision on the merits of the section 305 action* [here, 303 appeal] *moots all substantive issues brought before the Superior Court."* Having held the Commission's action in permitting and consolidating the § 291 complaint erroneous, any decision as to the jurisdiction of

[15] Significantly, the oil dealers in *Gifford* complained that as *ratepayers* they were aggrieved by CMP's practice of offering certain promotional allowances designed to encourage increased electrical use. Certainly the competitive disadvantage to the dealers presented by these allowances was obvious, yet was *sub silentio* found insufficient to disqualify them from a right to which they were entitled as ratepayers.

[16] All parties agree that 35 M.R.S.A. § 303 is inapplicable to this 80B appeal, concerning as it does only appeals to the Law Court from final Commission decisions.

the Superior Court to entertain an interlocutory appeal from such action would now be meaningless. Neither can the Superior Court, were we to decide it has jurisdiction (a question which we explicitly do not determine), provide any effective relief at this stage of the proceedings not already secured to Central Maine by our decision. Accordingly,

> *There being no issues remaining for the Superior Court to determine on the merits, CMP's appeal from that court's dismissal of its Rule 80B complaint must be denied for mootness. Central Maine Power Company v. Maine Public Utilities Commission, et al., supra,* 395 A. 2d at 434.

DEFERRED TAX ISSUE

I.

One of the principal issues raised in this appeal concerns CMP's taking of *"accelerated"* depreciation[17] over the useful life of its property. We have previously dealt with the proper treatment of accelerated depreciation for ratemaking purposes on many occasions. *See Continental Telephone Company of Maine v. Public Utilities Commission,* Me., 397 A. 2d 1001 (1979); *Mars Hill & Blaine Water Company, et al. v. Public Utilities Commission,* Me., 397 A. 2d 570 (1979); *Central Maine Power Company v. Public Utilities Commission,* Me., 382 A. 2d 302 (1978); *Mechanic Falls Water Company v. Public Utilities Commission,* Me., 381 A. 2d 1080; *Central Maine Power Company v. Public Utilities Commission,* 153

[17] The *"straight line"* method of depreciation allows the taxpayer to deduct from his taxable income equal annual amounts over the useful life of the asset. *"Accelerated"* methods allow greater deductions during the earlier years and lesser ones later in the asset's useful life. *See New England Telephone, supra,* at 18, n.3.

Me. 228, 136 A. 2d 726 (1956); and, most significantly for purposes of this case, *New England Telephone & Telegraph Company v. Public Utilities Commission,* Me., 390 A. 2d 8 (1978) (*"New England Telephone"* or *"New England"*).

Our decision in *New England Telephone* was announced shortly before conclusion of the hearings which underlie the present appeal. In the order reviewed in the *New England* case the Commission disallowed as a legitimate ratemaking expense federal income taxes deferred by New England's use of accelerated depreciation, action which increased the utility's net income and effected a *"flow-through"*[18] of the *"deferred"* taxes to the ratepayer. The Court reversed the Commission on this issue, holding that such an adjustment was

> *contrary to the established national economic policy established by Congress, and that the Commission's arbitrary treatment of New England's books of account in this respect and its placing of New England in jeopardy of losing its right to take such accelerated depreciation constituted an abuse of discretion.*

390 A. 2d at 12-13.

A brief review of the context and content of the *New England* decision is in order. As part of the ratemaking process[19] a utility presents its operating expenses incurred in the production of gross revenues. Included in such operating expenses is its tax expense. In *New England* the Company claimed $3,612,000 in *"deferred taxes"* for the test year 1976, representing taxes deferred by use of an accelerated rather than straight-line depreciation method, as provided under Internal Revenue Code § 167. New England sought to *"nor-*

[18] Under the *"flow-through"* method of ratemaking, utilities using accelerated depreciation for tax purposes must use the same method for calculating cost of service, and thus pass on any tax savings to their customers. *See New England Telephone, supra,* at 19, n.6.

[19] *See New England Telephone, supra,* at 18.

malize"[20] taxes thus deferred with respect to property acquired after 1969. The Commission, however, found that use of accelerated depreciation produced not merely a deferral of taxes, but an actual tax *savings.* The Commission thus increased the utility's net income by the amount of deferred taxes ($3,612,000) resulting in a *"flow-through"* to the ratepayers of the alleged *"savings."* 390 A. 2d at 18-19.

New England argued on appeal that this action would cause it to lose its right to take accelerated depreciation under Internal Revenue Code § 167(*l*). Although we noted that in similar circumstances courts and commissions of other jurisdictions had agreed with New England's claim, we found it unnecessary to reach that substantive issue, concluding instead that the Commission's disregard of New England's books of account[21] in order to impute flow-through *"was an arbitrary exercise of the Commission's power and constituted an abuse of its discretion"* as a matter of state law. 390 A. 2d at 23.

Although we stopped short of declaring that the Commission's action *would* cause New England to lose its ability to take accelerated depreciation, our finding of arbitrariness in

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[20] Normalization is the process by which a utility using accelerated depreciation for income tax purposes as if it had taken straight-line depreciation. Thus, initially at least, the utility is able to collect, as a component of its cost of service, a greater sum for tax expense than it actually pays. This excess amount is credited to a "*deferred tax reserve*", a bookkeeping device providing both expansion capital and a source of funds with which to pay later taxes which, at least in theory, will exceed revenues collected for taxes when a crossover point in the asset's life is reached. *See New England Telephone, supra,* at 18-19, n.4.

[21] The Commission ordered New England to continue to normalize its books of account, though it would impute flow-through of the tax deferrals, thereby disregarding the utility's book cost of service. We held it an abuse of discretion and an arbitrary exercise of power for the Commission to order New England to keep its books by one method while setting rates by another. *Id.*, at 22-23.

the Commission's action was based both on its disregard of the Company's books and its *"plac*[ing of] *New England in jeopardy of losing its ability to take accelerated depreciation."* 390 A. 2d at 24 (emphasis added). In dicta we noted *"considerable support," "*[s]*trong argument,"* and *"a reasonable likelihood" "strongly suggest*[ed]*"* by *"all indications"* that the utility's right would be forfeited if imputation of flow-through was upheld. *Id.*

Prior to announcement of the *New England* decision on June 28, 1978, the Commission staff had advocated a similar flow-through of deferred taxes with respect to Central Maine Power, whose rate case was then being heard before the Commission. On July 10, 1978, the first day of hearings following *New England Telephone,* Commission counsel presented this reaction.

> *Now in light of the Supreme Court ruling in the Telephone Company case with reference to deferred federal income taxes and flowing through the benefits of the same, we may very well take the position that deferred federal income taxes are customer contributed capital and, therefore, recommend disallowing depreciation expense thereon. And moreover, in connection with the same issue, I would also give notice that the staff can be . . . expected to take the position that the benefits of accelerated depreciation on post 1969 replacement property should be flowed through to the ratepayer.*[22]

To effect its determination not to allow Central Maine Power to take, for ratemaking purposes, depreciation on *"plant financed by deferred taxes"* the Commission applied

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[22] Only that portion of the Commission's Decree regarding depreciation on post-1969 *expansion* property is at issue in this appeal. *See* n. 29, *infra; Mars Hill & Blaine Water Co. v. Public Utilities Commission,* Me., 397 A. 2d 570, 580 (1979).

Central Maine Power's composite depreciation rate (3.32%) to its deferred tax reserve of $19,504,000, reducing depreciation expense by the resultant $648,000.[23]

The Commission adjustment entails computation of the Company's income *tax* expense using the full range and amount of depreciable property, but exclusion of *"property financed by deferred taxes"* in calculation of book *depreciation* expense.

The Commission's adjustment is premised on its contention that plant financed by the deferred tax reserve constitutes *"contributed property,"* as to which we have previously affirmed the propriety of disallowing depreciation expense. *Mechanic Falls Water Co. v. Public Utilities Commission,* Me., 381 A. 2d 1080 (1977).

The amount represented by the deferred tax reserve (averaging $19,504,000 during the 1977 test year) is indisputably non-investor supplied capital[24] upon which Central Maine Power is not entitled to a return, and which was, accordingly, deducted in calculation of the rate base. The Commission, however, explains that it *"reasoned that ratepayers, as the suppliers of the non-investor supplied capital, are also entitled to a return of their capital."* The Commission's disallowance in ratemaking of the depreciation of plant financed by this reserve was designed to secure for the ratepayers this *"return"* of capital, which would otherwise inure to the benefit of the Company.

In *Mechanic Falls, supra,* we defined *"contributed property"* as *"property a utility validly acquired by way of a voluntary donation."* 381 A. 2d at 1104, n.43. This definition has focused debate upon whether the tax reserve in fact is a *"voluntary donation,"* and if so, from whom it is received.

Central Maine contends that deferred taxes are not voluntary donations, but are simply a component of the revenue requirement collected through rates. No investment *"capital"* is supplied by ratepayers, but simply the cost of service, including a return for investors. Further, the Company argues, any *"capital contribution"* made is made not by the ratepayers but by the federal government, when it foregoes immediate collection of tax dollars to which it is entitled.

The Commission dismisses these arguments as mere semantics. The function of depreciation, it points out, is to recover the investment in property over the life of that property. Depreciation on contributed property is therefore disallowed not to credit the donees, but to insure that investors who did not supply capital for the contributed property do not recover on an *"investment"* they did not make. Therefore, whether the capital represented by the tax reserve is contributed by ratepayers or by the United States government, it assuredly is *not* supplied by the Company's investors, and should not therefore redound to their benefit.

By its own analysis, a further condition to the validity of the Commission's adjustment is that the capital contribution be a permanent one, which, in this context, means that the deferred taxes *"held"* in the reserve for future payment must in fact be *permanent* tax savings.

The Commission has taken the position that *"deferred"* taxes are actually permanent tax savings on several occasions prior to this case.

Here, a Commission staff witness testified at length on the subject, explaining that, in his view,

> *The only requirements for deferred taxes not to be paid*

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[23] The *"Maine jurisdictional"* portion of this sum is $641,500.

[24] Although there is some dispute as to who *does* supply this capital, *see, infra,* there is no question but that Central Maine Power's investors do not, and should not therefore earn a return on it. The accepted practice of excluding it from the rate base is not, therefore, challenged here. The Commission's further action in seeking to provide a return on that capital for the ratepayers, however, is the basis of the appeal on this issue.

is that depreciable plant does not decrease while the company has taxable income. In fact as long as the plant continues to grow, the taxes actually paid will always be less than those included as operating expense under the normalization method.

• • •

when looked at from the perspective of a single piece of plant liberalized depreciation simply provides for an accelerated of the depreciation deductions. However, when looked at from the perspective of reality, i.e., an entire utility plant, the total depreciation expense for tax purposes will always be greater than the straight line depreciation expense.

In sum, he concluded:

where depreciable plant continues to grow the tax depreciation deductions under liberalized depreciation provisions will always be greater than book depreciation using straight line . . . [U]nder such conditions the utility will continue indefinitely to realize tax savings and not just a tax deferral.

Courts and scholars, the Commission continues, have confirmed the truth of this analysis. This Court, it therefore urges, should defer to the discretion of the Commission in the realm of such economic fact-finding.

The Company, for its part, assails the Commission's presentation as a *"re-hash"* of its losing arguments before this Court in *New England Telephone.* In substance, we must agree.

It is true, as the Commission points out, that in 1957 we affirmed a Commission order that the benefits of the deferred tax reserve be flowed through to current ratepayers. *Central Maine Power Co. v. P.U.C.,* 153 Me. 228, 136 A. 2d 726, 737-739 (1957). As we observed in *New England Telephone,* however,

The 1957 Central Maine Power Co. case was decided in the context of federal tax law existing before the Tax Reform Act of 1969, which substantially affected the availability of accelerated depreciation to public utilities.

New England Tel. & Tel. Co. v. P.U.C., supra, 390 A. 2d at 16.

Thus we concluded, in the *New England* case,

. . . it is clear from reading the hearings, that the Congress recognized that when accelerated depreciation was used, no tax "savings" *were thereby affected, rather payment of the tax was* "deferred" *in part. The intended effect of this deferral was to create a deferred tax reserve which provided interest-free capital to the utility hopefully to be used for plant expansion.*

Id. at 18.

It was the enactment of § 167 (*l*), and the Congressional intent it evidences, which so clearly makes our 1957 *Central Maine* decision distinguishable. The crux of our decision there was that after a study of § 167 as then extant, we were

unable to find an intent on the part of Congress that the ratepayers of a regulated utility should provide an interest free loan to the Company through present payment of a deferred tax.

193 Me. at 248, 136 A. 2d at 738. We quoted this passage in *New England,* 390 A. 2d at 20, and while we sustained the appeal without further analysis of the Congressional intent underlying § 167(*l*), we implicitly concluded that our statement in the 1957 *Central Maine* case was no longer accurate.

Our extensive review of the Legislative history of § 167(*l*) in *New England Telephone* need not be reiterated here, except to note again our conclusion that Congress intended *"to create a deferred tax reserve which* [would provide] *interest free capital to the utility . . . for plant expansion."* A. 2d at 18.

If the action here taken by the Commission constitutes a flow-through of deferred taxes, it would, of course, deplete the source of interest-free capital Congress sought to insure by enacting § 167(*l*), and would thus be inconsistent with national economic policy. Simultaneously, it would[25] place Central Maine Power in jeopardy of losing its right to take accelerated depreciation for federal tax purposes, and therefore constitute *"an arbitrary exercise of the Commission's power and . . . an abuse of its discretion"* prohibited by state law. *New England Telephone, supra,* at 23.

The Tax Reform Act of 1969[26] added subsection (*l*) to § 167 of the Internal Revenue Code. As we noted in *New England Telephone,* 390 A. 2d at 17, the amendment was a reflection of Congressional concern over the double loss of tax revenues resulting from the combination of accelerated depreciation for computing federal taxes (leading to higher deductions) and flow-through for fixing rates (leading to lower rates and thus lower gross revenues). The addition of § 167(*l*) was intended *"in general to* 'freeze' *the current situation regarding methods of depreciation"* in public utilities. *H.R. Report No. 91-413,* 91st Cong. 1st Sess. (1969), *reprinted in* [1969] *U.S. Code Cong. & Admin. News,* pp. 1645, 1783, quoted in *New England Telephone Co. v. Public Utilities Commission, supra,* at 17.

As ultimately enacted, § 167(*l*) distinguishes between two types of public utility property: *"pre-1970 property,"*[27] (acquired before January 1, 1970) and all other property, designated *"post-1969 property."*[28] Post-1969 property is further divided between expansion[29] and replacement property. With respect to pre-1970 property a utility may use

1. Straight-line depreciation;
2. The method used prior to August 1969 if it also normalizes; or
3. Accelerated depreciation with flow-through, but only if that method was used prior to August 1969. [167(*l*) (1)].

With respect to post-1969 property, a utility may use:

1. Straight-line depreciation;
2. Accelerated depreciation with normalization; or
3. Accelerated depreciation with flow-through if the utility used flow-through prior to August 1969 [167(*l*) (1)].

3a. With respect to expansion property, utility could elect to abandon accelerated depreciation with flow-through in favor of normalization. [167(*l*) (4)(A)].

In *Mars Hill & Blaine Water Co. v. P.U.C.,* Me., 397 A. 2d 570, 578-581 (1979), we summarized our case law concerning Commission efforts to require flow-through and the effect of I.R.C. § 167(*l*) on a utility's ability to continue taking accelerated depreciation on its property:

> *Where we have found no conflict between the Commission's actions and section 167(l), we have continued to leave the treatment of accelerated depreciation to the Commission's discretion and expertise. Central Maine*

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[25] Assuming also, that contrary to the Commission's argument here, and in *New England Telephone,* 390 A. 2d at 22, n.9, action by a regulatory commission which violates § 167(*l*) will result in loss of the right to take accelerated depreciation on the part of the affected utility. *See* discussion of this issue, *infra.*

[26] *Pub. L.* 91-172, § 441(a) (1969).

[27] I.R.C. § 167(*l*)(1); *see Mechanic Falls Water Co. v. Public Utilities Commission,* Me., 381 A. 2d 1080, 1101 (1977).

[28] I.R.C. § 167(*l*)(2); *see Mars Hill & Blaine Water Co. v. Public Utilities Commission,* Me., 397 A. 2d 570, 580-581 (1979).

[29] *"Expansion"* property is that *"which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3)(A)* [e.g., utility services] *and does not represent the replacement of existing capacity."* I.R.C. § 167(*l*)(4)(A).

Power Co. v. Public Utilities Commission, supra (1978); Mechanic Falls Water Co. v. Public Utilities Commission, supra (1977). On the other hand, where we have found that the Commission's actions arbitrarily "jeopardized" *a utility's ability to take accelerated depreciation under section 167(l), we have held the Commission's actions to be an unreasonable exercise of power and abuse of discretion. New England Telephone & Telegraph Co. v. Public Utilities Commission, supra* (1978).

We went on to hold that, for federal tax purposes with respect to post-1969 property, flow-through is permissible, *"if the conditions provided by subparagraph (c)* [of § 167(*l*)(2)] *are met."* Those conditions are that the taxpayer-utility (a) have used a flow-through accounting method for its July 1969 period, and (b) not have made an election under paragraph (4)(A) of § 167(*l*) which would entitle it to *"avoid the effect of paragraph (2)(C)."* 397 A. 2d at 580. We found the water companies involved in *Mars Hill* to be subject to the operation of paragraph (2)(C) of § 167(*l*), having (a) presumably[30] used accelerated depreciation with flow-through during July 1969, and (b) having failed to produce evidence of an election under paragraph (4)(A) such as would exempt them from the effect of paragraph (2)(C). 397 A. 2d at 580. Accordingly, we distinguished *New England Telephone* (which had not used flow-through for its July 1969 accounting period) and held that the Commission might properly *"in its discretion, require* [the water companies] *to use accelerated depreciation with flow-through for post 1969 property for ratemaking purposes without jeopardizing* [their] *right to take accelerated depreciation." Id.*

[30] The Water Companies produced no evidence as to the accounting method used during the July 1969 accounting period. Accordingly, the Commission treated them as if they had used flow-through during that period, in light of the Commission's traditional policy of requiring such treatment. We affirmed. 397 A. 2d at 570-80, n.11.

In dicta we observed that

> *If the Water Companies had made a valid election under this subparagraph* [(4)(A)] *the available depreciation methods would be limited to those provided in § 167(l)-2(A) and (B), namely, straight-line depreciation or accelerated depreciation with normalization. Treas. Reg. § 1.167(l)-2(a)(1) (1978). See Federal Power Commission v. Memphis Light, Gas & Water Division,* 411 U.S. 458, 93 S. Ct. 1723, 36 L. Ed. 2d 426 (1973).

Id. at 580.

To paraphrase our conclusion in *Mars Hill,* the present case differs from *Mars Hill* in a crucial respect: Unlike the Water Companies, Central Maine Power was *not* subject to the operation of paragraph (2)(C) of I.R.C. § 167(*l*). Although, like the Water Companies (and unlike New England Telephone), Central Maine used accelerated depreciation with flow-through for its July 1969 accounting, it, unlike the Water Companies, exercised its option to avoid the effect of paragraph (2)(C) by making a valid election under paragraph (4)(A) of § 167(*l*). Having done so, its *"available depreciation methods* [are] *limited to those provided in § 167(l)-2(A) and (B), namely, straight-line depreciation or accelerated depreciation or accelerated depreciation with normalization." Id.* at 580.

The issue is thus squarely presented: does the Commission adjustment place Central Maine in jeopardy of losing its right to take accelerated depreciation by departing from the requirements of normalization?

Section 167(*l*)(3)(6) of the Internal Revenue Code provides:

> *Normalization Method of Accounting. — In order to use a normalization method of accounting with respect to any public utility property —*
>
> *(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation*

expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

Central Maine contends that the Commission's disallowance of depreciation on plant financed by deferred taxes violates the normalization requirement of § 167(*l*) by calculating depreciation expense for ratemaking purposes differently from income tax for ratemaking purposes. That is, while the Commission calculates CMP's tax expense using the full amount of allowable depreciation, it calculates CMP's depreciation expense *excluding "depreciation on property financed by deferred taxes."*

Though the Commission *"purports"* to require the Company to depreciate *all* its property on its books, CMP argues, its refusal to allow *all* such depreciation for ratemaking purposes means that CMP will *not* be normalizing within the meaning of § 167(*l*), and will lose its right to use accelerated depreciation.

The Commission, however, contends that its adjustment poses no possibility of adverse tax consequences because, first, § 167(*l*) regulates only the *taxpayers's* method of accounting on its regulated books of account, not a regulatory commission's ratemaking methodology, and, secondly, in any event it constitutes not a different method of depreciation, but merely a change in the *basis* of CMP's depreciable assets.

As to its first point, the Commission notes the absence of statutory language applicable to regulatory methodology, and expressions of Congressional intent that normalization

not interfere with the prerogatives of state regulatory commissions. While differing interpretations of § 167(*l*) abound in the legislative history, the Commission continues, the principal author of the scheme[31] viewed it as applicable only to the utility's accounting methodology, and not to state regulatory policies. *Hearings on H.R. 6659, House Comm. on Ways and Means,* 91st Cong., 1st Sess. at 3850-54 (1969). Accordingly, it is argued, a ratemaking adjustment could not and has not placed CMP in jeopardy of losing its right to take accelerated depreciation.

As to the second point, the Commission found, and now contends, that its adjustment is — if in fact it must be — entirely consistent with a normalization method of accounting, entailing only an adjustment in the depreciable *basis* of CMP's assets. It must be noted, the Commission argues, that no adjustment to CMP's *tax* expense was made;[32] the reduction in *book* depreciation expense was made solely to account for the portion of CMP's depreciable property financed not by investor supplied capital, but by contributed capital. Finding it impossible to trace the capital source of any given asset, the Commission used the Company's composite depreciation rate in its calculations, assuming that an equal portion of each depreciable asset had been financed by contributed capital. In

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[31] Dr. Homer A. Black, Chairman of Accounting, Florida State University. Without directly contesting this point, CMP cites Doctor Black's testimony during the same hearings in support of its arguments against the Commission's contributed capital/permanent tax savings theory.

[32] CMP's test year taxes were computed as if the Company were using straight-line depreciation, when in fact accelerated depreciation was used. The Commission acknowledges that it flowed through the benefits of accelerated depreciation for the purposes of *state* income tax and federal income tax on *replacement* property. The present appeal does not challenge these adjustments. *Central Maine Power v. Public Utilities Commission, supra* (1978); I.R.C. § 167(l)(2)(C).

effect, then, the Commission contends, it merely adjusted the depreciable *basis* of every depreciable asset of CMP to account for that portion financed by customer-contributed capital. While the result as to each asset is a slightly different depreciable basis for tax purposes than for book depreciation purposes, such a difference in basis does not constitute a different *method* of depreciation under § 167(*l*)(3)(6). In fact, the Commission argues, the depreciable basis of an asset for tax purposes often varies from its depreciable basis for book purposes, due to Commission policies on construction work in progress (CWIP) and the allowance for funds used during construction (AFUDC). Different *amounts* of depreciation are thus often used in computing tax expense and in computing depreciation expense for establishing cost of service and for reflecting operating results on its books of account. This use of differing amounts of depreciation resulting from different depreciation bases does not constitute use of different methods of depreciation, and does not violate normalization methods. *S. Rep. No. 91-552,* 91st Cong., 1st Sess., *U.S. Code Cong. & Adm. News,* 2027, 2207 (1969); *Treas. Reg.* § 1.167(*l*)-1(a)(2).

In sum, the Commission argues, its adjustment of CMP's book depreciation expense left the Company's tax expense undisturbed, and therefore did *not* flow-through the benefits of accelerated depreciation. The adjustment, rather than flowing through such benefits, merely reflected the economic reality that investors have not supplied all the capital used to finance CMP's depreciable assets.

We find the Commission's first point to be untenable. Again, without reiterating our review of the Legislative history of § 167(*l*) presented in *New England Telephone, see* 390 A. 2d at 22, n.9, we think it clearly implied there that regulatory commission imposed accounting methods which violate the Internal Revenue Code will penalize the subject utility, irrespective of its reluctance to adopt such methods. A contrary conclusion would ask us to believe that Congress intended the strictures of § 167(*l*) to be merely advisory; that if state regulatory agencies wished to defy national economic policy they were free to do so. Moreover, even a cursory reading of the I.R.S. Regulations and Private Letter Rulings[33] cited to us makes clear that, even if imposed by a regulatory body, accounting methods which violate § 167(*l*) will produce adverse tax consequences for the affected utility.

We also reject the Commission's argument that its adjustment constitutes a mere change in basis. While it is true that the Commission did not *directly* adjust Central Maine Power's tax expense, we do not find that determinative of the issue.

We have said before that a regulatory agency may not do by indirection what is forbidden it to do directly. *Peggy S. M. v. State,* Me., 397 A. 2d 980, 983 (1979). If it is forbidden to directly flow through the benefits of accelerated depreciation, it is forbidden to impose an adjustment having the same effect, i.e., one inconsistent with full normalization.

Full normalization requires that the *entire* deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account (namely, straight-line), and (b) the accelerated depreciation method used on the income tax return, be normalized. The methodology, employed by the Commission results, instead, in a partial flow-through of those deferred taxes. That this end is accomplished not directly but by excluding from book depreciation a portion of the value of depreciable assets allowed for tax purposes under the rubric of a *"basis"* change is irrelevant. In either case normalization (and Congressional intent) is frustrated. In either case the amount of deferred taxes properly includable in the cost of service is reduced, to the

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[33] See discussion of this authority, *post.* at pp. 49-53.

benefit of the ratepayers and to the detriment of the utility and national economic policy. Without ordering a change in Central Maine Power's accounting methods, the Commission adjusted its book depreciation expense to account for what it considers non-investor supplied capital. That adjustment was made by applying Central Maine Power's composite depreciation rate to its total deferred tax reserve. That deferred tax reserve was computed on the basis of accelerated depreciation. Staff witness Louiselle confirmed the intent and result of this process:

> *Q. Under the method that you're proposing here, you're asking that this Commission for ratemaking purposes disallow depreciation expense on that part of utility property financed by deferred taxes even though CMP is permitted to take depreciation expense thereon for tax purposes, are you not?*
>
> *A. Yes, sir.* (emphasis added).

The I.R.S. has ruled, however, in each of the private rulings referred to above,

> *that to use a normalization method of accounting . . . the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account.* (emphasis added).

The Commission's adjustment departs from the definition of normalization by requiring calculation of depreciation expense for ratemaking purposes differently than for tax purposes. That is, CMP's tax expense is computed as if it were taking straight-line depreciation; since in fact it is taking accelerated depreciation the difference between taxes actually paid and those due under a straight-line method must be credited to a deferred tax account. By using CMP's composite depreciation rate times its deferred tax reserve to equal book depreciation expense, the Commission was effectively using accelerated depreciation to compute depreciation for ratemaking purposes and straight-line depreciation to compute depreciation for tax purposes.

Congress forbade different methods of depreciation for tax and ratemaking purposes in order to provide interest-free investment capital for utility expansion. Regulation which results in the *"loan"* being extended (by virtue of accelerated depreciation) but also in the utility being forced to divert a portion of it to other uses as income (by virtue of it being denied as an expense) does not comport with Congressional intent. The result must surely be denial of the *"loan,"* i.e., the loss of the right to accelerate depreciation.

As we observed in *New England Telephone,* normalization of a utility's regulated books of account does not meet the § 167(*l*) requirement of normalization if these books may be disregarded by the Commission in setting rates. Where the Commission sets rates reflecting a lower depreciation expense than it permits to be taken for tax purposes, a partial flow-through *results* (whether the Commission wishes to thus characterize it or not) in the form of lower rates. The utility thus loses, as a direct consequence, the full benefit of the deferred taxes it is allowed, and is further placed in jeopardy of losing entirely its right to take accelerated depreciation.

Both Internal Revenue Service Regulations and two Private Letter Rulings stemming from California Public Utilities Commission action graphically illustrate that it is the *effect,* rather than the *form,* which must be considered in determining the risk to a utility of losing its right to accelerated depreciation. *"Examples 4 and 5"* accompanying I.R.S. Regs. § 1.167(*l*)-(h)(2)(ii) demonstrate the significance of the effects present here:

> *Example (4). Corporation Z, exclusively engaged in a public utility activity did not use a flow-through method of regulated accounting for its July 1969 regulated accounting period. In 1971, a regulatory body having juris-*

diction over all of Z's property issued an order applicable to all years beginning with 1968 which provided, in effect, that Z use an accelerated method of depreciation for purposes of section 167 and for determining its tax expenses for purposes of reflecting operating results in its regulated books of account. The order further provided that Z normalize 50 percent of the tax deferral resulting therefrom. Under section 167(l), the method of accounting provided in the order would not be a normalization method of regulated accounting because Z would not be permitted to normalize 100 percent of the tax deferral resulting from the use of an accelerated method of depreciation. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) [i.e., straight-line] *method of depreciation.*

Example (5). Assume the same facts as in example (4) except that the order of the regulatory body provided, in effect, that Z normalize 100 percent of the tax deferral with respect to 50 percent of its public utility property and flow-through the tax savings with respect to the other 50 percent of its property. Because the effect of such an order would allow Z to flow-through a portion of the tax savings resulting from the use of an accelerated method of depreciation, Z would not be using a normalization method of regulated accounting with respect to any of its properties. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

I.R.S. Reg. § 1.167(*l*)-(h)(2)(ii), Examples 4 and 5 (Emp. added).

The Commission's treatment of CMP's depreciable property may be profitably analogized to that involved in Example (5). In each case the Company's property was divided; in CMP's case, into *"plant financed by deferred taxes"* and remaining plant. Normalization was employed as to the latter

portion, while (proportionate) tax savings attributable to the former were passed on to ratepayers by virtue of the concomitant reduction in CMP's cost of service. Because the *effect* of the Commission's order is *"to flow-through a portion of the tax savings resulting from the use of an accelerated method of depreciation,* [CMP] *would not be using a normalization method . . . with respect to any of its properties."* Example (5), *supra.*

The Commission's brief itself proclaims that *"*[t]*he most significant events outside the State of Maine since the 1978 New England case relate to the California Public Utilities Commission's treatment of deferred taxes,"* citing *Pacific Telephone & Telegraph Company, et al.,* — P.U.R. 4th — (Cal. P.U.C. 1977).[34] More significant, however, is the initial I.R.S. reaction to that decision.

The California commission, in a case comparable to the present one, devised *"a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes."* To do so it calculated an *"average deferred tax reserve"* based on a three-year forward projection, and deducted it from the test year rate base to determine revenue requirements. As a result, both rate base and revenue requirements were lower than they would have been had only the text year reserve been deducted. In private revenue rulings, the I.R.S. has advised the affected companies that — if and when the decision becomes final — they will lose their right to accelerated depreciation for federal income tax pur-

[34] The Commission cites this consolidated case in support of its contention that ratemaking adjustments by a regulator cannot violate the normalization requirement to the detriment of the utility. That both the California and United States Supreme Courts have denied *certiorari,* it argues, supports this reading of § 167(*l*). *Pacific Tel. & Tel. v. Public Utilities Commission of California,* — U.S. —, 99 S. Ct. 733, 58 L.Ed.2d 713 (1978); *General Tel. Co. of California v. Public Utilities Commission of California,* — U.S. —, 99 S. Ct. 734, 58 L.Ed.2d 713 (1978); 47 L.W. 3395 (12/5/78).

poses, since the Commission action violates normalization principles. *I.R.S. Private Letter Ruling* 7836038 (June 8, 1978); *I.R.S. Private Letter Ruling* 7836048 (June 9, 1978).

The latter ruling, pertaining to an *"average annual adjustment method"* of determining deferred taxes to be allowed in setting rates, concluded that

> *[w]e believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(l) of the Code.*

Suggesting that, in order to avoid causing the utility the loss of accelerated depreciation, the Commission might wish to amend its decision to eliminate its averaging calculations, the Ruling advised that

> *it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and . . . the taxpayer would no longer be eligible to use an accelerated method of depreciation.*

Ruling 7836048, *supra* (emphasis added).

Although the method employed here *directly* reduced tax expense for ratemaking purposes beyond what was the actual test year expense, the *result* was precisely that aimed for by the Commission in the instant case: a lower overall cost of service, resulting in lower rates. The emphasis in the quoted portion of the Ruling on consistency between tax expense and the tax reserve is the crux of the issue. Where X amount

has been *"loaned"* to be placed in the reserve, equivalent tax expense must be allowed in ratemaking. Where, as here, the amounts of depreciation used for tax and ratemaking purposes differ, a portion of the *"loan"* cannot be used as intended, but must be employed to compensate for the reduction made in cost of service and book depreciation expense.

I.R.S. Regulation § 1.167(*l*)-(h)(2)(i) states that when a taxpayer uses a normalization method of accounting it *must* credit the amount of deferred taxes. Here, the full amount of deferred Federal income tax produced by accelerated depreciation cannot be credited to the reserve: accordingly, normalization is precluded.

In *New England Telephone, supra,* at 20-21, we noted that the legislation (H.R. 6659) which culminated in § 167(*l*) was originally directed explicitly at the practices of regulatory agencies, rather than regulated taxpayers. As finally enacted, however, it was facially limited to prescribing the methods of depreciation available to the utilities themselves, meaning that *"[a]ny effect upon regulatory agency policies was to be as an indirect result of the statute's provisions"* governing utilities. *Id.* at 21.

As originally directed at regulators, the amendment specifically forbade two methods of flow-through, and concluded, *"(c)* [or] *accomplish a result similar to those proscribed by paragraph (a) or (b) by any other treatment, device, or procedure."* *Id.* (Emphasis added).

Section 167(*l*) as finally enacted omits such a catch-all provision, since it is directed at the utilities themselves, for whom it is unnecessary. As we have found, however, regulation which violates normalization will penalize the subject utility. We conclude that Congress — as indicated by this seminal expression of intent, and by subsequent I.R.S. pronouncements enforcing it — wished to insure that the *full* benefit of deferred taxes remain within the corporation, and sought accordingly to prohibit flow-through or "any other treatment, device, or procedure" having the same effect.

We therefore conclude that the Commission action with respect to this issue is erroneous insofar as it seeks to disallow depreciation expense on *"plant financed by deferred taxes"* by a reduction in book depreciation expense. Accordingly, on remand, Central Maine Power is to be allowed to file rates designed to produce additional revenues of $641,500, representing the erroneous reduction in revenue requirements attributable to this error.

EMPLOYEE DISCOUNT ISSUE

Full time and retired Central Maine Power employees receive, and have received for many years, a one-third discount on their residential electric bills, excluding fuel charges. This employee discount was held by the Commission to be *"not a reasonable form of employee compensation"* in these circumstances,[35] and its cost disallowed as an expense for ratemaking purposes. The disallowance increased Central Maine Power's net operating income by $121,000.

The Commission's rationale was:

> *. . . Central Maine's discount is not a reasonable form of employee compensation. The level of benefits received by any given employee depends solely upon his or her level of electricity use, not upon his or her position with the Company, similarly, salary, or any other objective standard for employee compensation. The same is true for the discount as applied to retired employees.*
>
> *In this era of energy shortages and rising marginal costs of producing electricity, we find it unreasonable for the Company to provide a discount in order to promote electricity use.*

We sustain Central Maine Power's appeal on this issue.

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[35] The Commission did recognize that the cost of discounts *"in some instances may be chargeable to ratepayers as a reasonable form of employee compensation."*

We begin by noting that 35 M.R.S.A. § 103 provides in relevant part, *"nor shall it be unlawful for any public utility to make special rates to its employees . . ."* The Commission, however, contends that notwithstanding the legality of such discount, its promotional effect makes it unreasonable in the present period of energy shortages and rising marginal costs of producing electricity. The Commission reasons, its mandate under 35 M.R.S.A. § 51 to insure *"just and reasonable"* rates justified its disallowance.

In *New England Tel. & Tel. Co. v. Public Utilities,* 390 A. 2d 8 (1978), we held that the Commission properly deducted $16,000 of charitable contributions and $1,000 in lobbying expenses from New England's operating expenses for ratemaking purposes. 390 A. 2d at 55-57. We there agreed with the Commission that whether to allow such costs to be deducted as ratemaking expenses is *"inherently a policy decision."* 390 A. 2d at 55. The Commission now urges that we declare the matter of employee discounts to likewise be a policy matter primarily entrusted to the Commission's discretion.

This we decline to do.

The Commission cites *Re Chesapeake and Potomac Telephone Co.,* 16 P.U.R. 4th 314, 316 (D.C. P.S.C. 1976) as at least one commission which has *"expressly recognized"* that the regulatory treatment of discounts is a matter of policy within Commission's discretion. Although we are not wholly convinced that the citation provided necessarily stands for that proposition,[36] we do not in any event find it determinative.

The Commission's first objection to the discount is that it is provided to all qualified employees without regard to position, seniority, or other differentiating factors.

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[36] The citation provided reads, in relevant part:

> *The Commission has decided that continuation of the employee discounts offered to the company employees is justified as a matter of regulatory policy.* 16 P.U.R. 4 at 316.

The Commission has routinely recognized the propriety, in past rate cases, of undifferentiated employee benefits such as insurance and hospitalization costs. We note, also, that discounts which differentiate by seniority, salary, or status have been treated critically by commissions in other jurisdictions. *See, e.g., Re: Chesapeake & Potomac Telephone Co. of Maryland,* 13 P.U.R. 4th 293, 303 (Md. P.S.C. 1976); *Re: Michigan Bell Tel. Co.,* 15 P.U.R. 4th 209, 219-20 (Mich. P.S.C. 1976); *Re New England Tel. & Tel. Co.,* 11 P.U.R. 4th 297, 303 (Mass. D.P.U. 1975). Without deciding whether discounts, if offered, *must be* undifferentiated, or that, as the Michigan P.S.C. concluded *"[n]o rational explanation . . . justifies additional benefits to certain employees to the exclusion of others,"* 15 P.U.R. 4th at 220, we can discern no legitimate objection to a lack of differentiation.

The Commission's second ground for objection is that the discount is promotional of electrical use and thus unreasonable in an era of energy shortages. Central Maine Power argues that no evidence or argument was presented to show that employees' electrical consumption is greater than non-employees' because of the discount, and that *"a finding of unreasonableness [of the discount] cannot be made on the basis of such a bare record as was made here." Berry v. Maine Public Utilities Commission,* Me., 394 A. 2d 790, 794 n.13 (1978). The Commission, however, assembles in its brief portions of testimony which, when combined and analyzed, allegedly demonstrate such excessive consumption.[37] Both Central Maine Power and the Commission agree that the discount was originally offered for promotional purposes in earlier years of energy surpluses; both parties now agree that promotion of electrical consumption is to be avoided.

[37] Testimony established that in 1977 some 2,000 employees used approximately 28.8 million kilowatt hours (KWH); that average annual use by residential space heating customers is approximately 15,000 KWH; and that average annual residential use is approximately one-third that amount. Thus, the Commission contends, record evidence demonstrates that average employee use of approximately 14,400 KWH annually (28.8 million divided by 2,000) far exceeds average non-employee consumption.

We do not consider this *"substatial evidence"* in support of the Commission. Our inspection of the record discloses no testimony directly aimed at establishing this promotional phenomenon, and, more importantly, no suggestion that the issue was ever fully and appropriately contested before the Commission.

The issue was casually injected into the proceedings by the Chairman's question to Central Maine Power's President:

> Q. . . . *There are a couple of areas that I find as Chairman that I frequently get in the form of letters, et cetera, and it's not really, you know, something that you talk about in a rate case, but I'm just going to mention at least one of them at this time, and that involves really the area of employee discounts, because I don't know who else to ask this, and I've never had an opportunity, and there's hardly a month goes by that I don't get a phone call or a letter about employee discounts. What's your policy on employee discounts?*

There followed brief quizzing on the mechanics of the policy, its rationale, and 35 M.R.S.A. § 103, of which at least two commissioners were then unaware. Immediately following this questioning Commission staff was offered an opportunity to question the witness. Despite the immediately preceding revelations, the staff declined to pursue the issue.

The difficulties engendered by a failure to fully develop the issue below are illustrated by the Commission's argument. Shortly after Central Maine's Power's President cited the 15,000 KWH figure for space heating customers he stated, in response to the same question from another questioner, that the figure was *"probably 15 or 20,000"* KWH annually. Obviously, a recomputation using the higher figure yields far different results. If the Commission wished to base its decision on this computation it should have provided the utility an opportunity to contest its probity. Without information, for example, as to the number of employees who are space heating customers, the figures are of little value, and may be enormously misleading.

ly frequent attack. *See, e.g., Re Chesapeake & Potomac Tel. Co.,* 16 P.U.R. 4th at 315 (D.C. P.S.C. 1976); *Re Michigan Bell Telephone Co.,* 15 P.U.R. 4th 209, 220 (Mich. P.S.C. 1976); *Re Mountain States Tel. & Tel. Co.,* 95 P.U.R. 3d 130, 133 (Colo. P.U.C. 1972). Significantly, however, in each of these instances the commissions ultimately allowed the discounts, except to the extent that they exceeded an approved tariff or differentiated among employees (*e.g., Re Michigan Bell, supra*) or applied during system peaks (*Re Mountain States Tel. & Tel. (Colo.), supra*).

The regulatory commissions approving such discounts have cited several factors which we find relevant here. First, several commissions have given weight to the reliance on past practice by recipients of the discount. Accordingly, they have either wholly upheld the practice, *Re Chesapeake & Potomac Tel. Co.,* 16 P.U.R. 4th 314, 315 (D.C. P.S.C. 1976) or continued it as to retirees while gradually phasing it out as to those found ineligible, *Re Chesapeake & Potomac Tel. Co. of Maryland, supra* at 301-303; *Re Mountain States Tel. & Tel. Co.,* 95 P.U.R. 3d 130, 133-134 (Colo. P.U.C. 1972).

However, the determinative factor in most cases has been either the practical effect of discontinuing the discount (i.e., the prospect of a demand for corresponding wage increases) or a reluctance to interfere with the understandings reached between a utility and its employees. Our decision turns on the latter factor, although we are not unmindful of the significance of others discussed in the cases.

In *Central Maine Power v. Public Utilities Commission,* 153 Me. 228, 136 A. 2d 726 (1958) we sustained Central Maine Power's appeal from a Commission ruling excluding certain promotional expenses from the revenue required. We there cited *West Ohio Gas Co. v. Public Utilities Commission of Ohio,* 294 U.S. 63, 72, 55 S. Ct. 316, 321, 79 L. Ed. 791 (1935): *"[g]ood faith is to be presumed on the part of the managers of a business. . . . In the absence of a showing of inefficiency or improvidence, a court will not substitute its judgment for theirs as to the measure of a prudent outlay."* Similarly, we accepted the principle, articulated by the Supreme Court of Vermont, that

> *The function of a public service commission is that of control and not of management, and regulation should not obtrude itself into the place of management.*
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> • • •
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> *This rule is recognized in all of the cases. This matter of salaries and advertising expense calls for the exercise of judgment on the part of the management of the company. Good faith on its part is to be presumed. Although these expenses should be scrutinized with care by the commission they should not be disallowed or reduced unless it clearly appears that they are excessive or unwarranted or incurred in bad faith.*

Petition of New England Tel. & Tel. Co., 115 Vt. 494, 66 A. 2d 135, 145 (1949).

Employee discounts are indisputably a form of employee compensation. Whether directly incorporated within a collective bargaining agreement, or merely a standard and accepted pre-requisite of employment, such discount surely constitutes value given the employees by the Company in partial exchange for past or present services.[38] We, therefore,

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[38] Concurring in the majority opinion in *Re General Tel. Co. of Florida,* 19 P.U.R. 4th 227, 267 (Fla. P.S.C. 1977), Commissioner Bevis observed:

> *Whether a person works for a small business, a large corporation, a governmental agency, or a regulated utility, it is almost universal practice for that person to receive some part of the total renumeration for his work in a form other than cash. Some common forms of this type of renumeration are partial or total payment of his group health and life insurance premiums, payment of a share of his unemployment compensation for workmen's compensation insurance, the grant of price dis-*

discern no good reason for distinguishing between management prerogatives respecting salaries recognized in our 1958 *Central Maine Power* decision and those applicable to the matter of employee discounts.

The employee discount at issue here does not constitute *"undue or unreasonable"* discrimination, prohibited by 35 M.R.S.A. § 102. Ruling on a challenge to telephone service discounts provided clergy, newspapers, municipalities, and employees, the Arizona Corporation Commission invalidated those in the first three categories, but held that the employee discount

> *is not discriminatory as it is given in partial consideration to the employee for services provided to the company and can be justified on that basis.*

Re The Mountain States Tel. & Tel. Co., 8 P.U.R. 4th 547, 556 (Ariz. C.C. 1975). Moreover, the Legislature's specific exemption of, *inter alia*, a utility's employees from the prohibition in § 103 of *"rebate[s] discount[s] or discrimination"* adequately answers challenges premised on § 102.

There is some dispute whether, were a discount disallowed, a utility's expenses would ultimately be reduced. Nearly every commission upholding such discounts has concluded

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counts on the purchase of goods or services which that particular company sells, participation in retirement plans, reduced prices for meals in company lunchrooms, establishment of deferred compensation plans, provision of moving expenses for families, provision of tools and work clothes and many, many others.

Some of these forms of renumeration are even required by law to promote the social well-being of the employee and his family. Whether these forms of renumeration are called concessions, fringe benefits, employee discounts, or some other name, and whether or not they are required by law, all of them accrue to the benefit of the employee. They have a bearing upon whether or not the person (management or craft) will trade his skills and work he can perform for a total package of renumeration (cash plus noncash).

that denial of discounts would result in employee demands for equivalent compensation. *"Equivalent"* cash compensation, several commissions have observed, would in fact likely be more expensive than *"free"* service.[39] Whether this phenomenon would in fact occur is a *"question . . . not free from doubt." Re Chesapeake & Potomac Tel. Co., supra* at 315, citing 15 P.U.R. 4th 302.[40] It is a question, however, that we find unnecessary to resolve.

The New York Public Service Commission, considering this issue some 25 years ago, concluded that abolition of the discount would not result in a saving to the public. They continued:

> *That alone would be sufficient reason to refuse to prohibit the practice but this decision is not based on such narrow grounds.*

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[39] Dissenting from the Colorado Public Utilities Commission's conclusion that employee discounts are discriminatory, and that equivalent compensation would be *"insignificant"*, Commissioner Lundborg argued:

> *This reason completely ignores the uncontradicted testimony of at least two witnesses that it would be necessary to* "gross up" *payments to employees in order to leave them in precisely the same economic position after discontinuance of concessions as before—i.e., to offset federal and state income taxes, sales taxes, social security, etc.—it would be necessary to pay the employees far more than the present nonbilled paper dollar value of the concession itself. The most conservative estimate of the* "gross up" *would be a substantial sum which—contrary to the public interest—must unreasonably be borne and paid by the general body of ratepayers.*

Re Mountain States Tel. & Tel. Co., 95 P.U.R. 3d 130, 135-136 Colo. P.U.C. 1972) (Lundborg, Comm. Dissenting); *See also, Re Chesapeake & Potomac Tel. Co. of Md., supra* at 303 (implicitly); *Re General Tel. Co. of Fla.*, 19 P.U.R. 4th 227, 268 (Fla. P.S.C. 1977) (Bevis, Comm. concurring).

[40] In these two decisions the District of Columbia Commission reversed itself on the issue, finally determining that the discounts were justifiable as a matter of regulatory policy.

> *The Commission has repeatedly asserted its position that it will not interfere with the collective bargaining rights which have become inherently part of our American system and that any payment or benefit given labor, in the absence of proof of bad faith, is presumptively a proper expenditure of fixing rates. Any effort on our part to curtail or limit a reduced telephone rate to employees would be as improper as if we were to attempt to fix the number of paid holidays or limit any other right which has been given as a result of an understanding between employer and employee.*

Re New York Telephone Co., 5 P.U.R. 3d 33, 58 (N.Y.P.S.C. 1954). *See also, Re Chesapeake & Potomac Tel. Co.*, 36 P.U.R. 3d 417, 424 (W. Va. P.S.C. 1960).

A regulatory commission owes a degree of deference to the judgment of management in the establishment of employee compensation packages. Where, as here, the road chosen by management is arguably at least as economical as any alternative, and the benefit does not clearly appear to be *"excessive, or unwarranted, or incurred in bad faith,"* management's judgment must be respected. *Central Maine Power Co. v. Public Utilities Comm.*, 153 Me. 228, 244, 136 A. 2d 726, 736 (1958).[41] *See Berry v. Maine Public Util. Comm., supra* at 794; *Cf. Casco Bay Lines v. P.U.C.*, Me., 390 A. 2d 483, 494 (1978) (liability insurance expense).

We need not, and do not, decide that the entire spectrum of matters relating to employee compensation is beyond the reach of the Commission's regulatory powers. We have clearly held to the contrary in the past. *See e.g., Casco Bay Lines v.*

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[41] Although the Commission argues that its disapproval of the discount constitutes not interference with management but merely a policy determination, it contends in a footnote to its brief that the Company's action nevertheless falls within the standard cited here. Our examination of the record and of the Commission's findings does not allow us to accept that conclusion.

Public Utilities Comm., supra at 492-494. We hold only that we cannot find, in this record, any substantial evidence justifying the Commission's interference with a reasonable managerial judgment.

CAPITAL STRUCTURE ISSUE

One of the primary functions of regulatory agencies in the ratemaking process is the determination of the appropriate rate of return to be allowed utilities under its jurisdiction. Rate of return, i.e., the annual return to be allowed on the value of the utility's property devoted to public use, is determined by combining the capital structure of the utility with the proper cost of capital. *Mechanic Falls, supra,* at 1095. In a lengthy discussion of the rate of return issue in *New England Telephone, supra,* we observed that

> *[i]t can be seen that the cost of capital depends not only upon the individual cost of the different items* [i.e., debt & equity] *making up a utility's capitalization, but also upon the proportion of those individual items to the total capital structure.*

390 A. 2d at 39.

We also observed there that *"a higher* 'debt ratio' *means lower rate of return and lower rates to the utility's customers." Id.*

In the present case the Commission found that a capital structure containing 35 percent common equity, 13 percent preferred and 52 percent debt was appropriate for Central Maine and should be used to determine its rate of return. The Decree stated:

> *. . . Central Maine's pro forma equity ratio of 36.6% is unreasonable and inefficient because it provides an excessive and unnecessary margin of safety which is being financed by ratepayers. For these reasons, we find that a capital structure containing 35% equity, 13% preferred,*

and 52% debt is appropriate and should be used to determine the fair rate of return.[42]

Central Maine submits on appeal that this finding of unreasonableness was erroneous and without record support. Specifically, they contest what they contend is the Commission's inappropriate use of a hypothetical capital structure in lieu of their pro forma structure, which they insist was reasonable.

The Commission, in reply, argues alternatively that it found Central Maine's near term *pro forma* capital structure rather than a hypothetical one, but that in any event use of a hypothetical structure would be justified and supported by its findings.

We deny Central Maine's appeal on this issue, finding the Commission's use of a hypothetical capital structure to be reasonable and supported by substantial evidence.

In *Mars Hill & Blaine Water Co. v. Public Utilities Commission, supra,* we upheld the Commission's substitution of a 60/40 capital structure for the utilities[43] actual 57/43 capital structure *"as constituting a reasonable exercise of the Commission's expert judgment."* 397 A. 2d at 583. We did so after finding that *"[t]he record supports the conclusion that General Waterworks was attempting to shift to a 60/40 capital structure and that the ratepayers have been incurring higher debt costs associated with the attempt." Id.* Ratemaking being prospective in nature, we said, *"facts which with certainty will gain life in the future, but do not affect the operations for the test year, must be weighed by the factfinder. . . ." Id.* at 584, *quoting Central Maine Power Co. v. Public Utilities Comm.,* 153 Me. 228, 242, 136 A. 2d 726, 735 (1957).

[42] The pre-filed direct testimony of Central Maine Power's Vice President for Finance, Mr. Webb, set the Company's pro forma equity ratio at 36.6%. During subsequent cross-examination Mr. Webb revised this figure to 36.15 (rounded to 36.2%) to reflect intervening events.

[43] All of the utilities involved were subsidiaries of General Waterworks Corporation, which was in turn wholly owned by I.U. International Corporation. All parties agreed that, for reasons discussed *infra,* the capital structure of General Waterworks must be at least the starting point for analysis of the cost of capital for each of the subsidiary utilities. Thus it was considered the *"actual"* capital structure of the subsidiaries.

The Commission contends that it found and employed Central Maine Power's near term pro forma actual capital structure rather than a hypothetical one, citing principles announced in *Mars Hill, supra.* A review of the record, briefs, and decision in that case, however, discloses no hint that the Commission argued — or this Court held — that the capital structure there imputed to the utilities was anything but hypothetical. Indeed, the Commission's brief to this Court in that case pointed out:

> *Because the Companies do not issue their own debt, their actual capital structure is 100% equity. All parties agree that a 100% equity capital structure would be unreasonable for ratemaking purposes. The issue, therefore, is what hypothetical capital structure should be imputed to these General Waterworks subsidiaries. Accordingly, since neither the Commission, nor the Company, is advocating the actual capital structure of these Companies for ratemaking purposes, appellants' extended discussions of cases dealing with actual versus hypothetical capital structures are irrelevant.* (original emphasis).

Although we did not specifically refer to the capital structure used by the Commission as *"hypothetical,"* we referred to it as the *"appropriate"* one, as distinguished from the actual one. A *"hypothetical"* capital structure is not one created of thin air: for that reason the term is misleading. It is *"hypothetical"* only to the extent that it assumes, as it must, certain trends in the financing of the utility during the future period for which rates are being set. It must, however, be based in present fact and future probability, which in the ordinary case means that the present actual capital structure of

the Company must be the starting point for analysis.

Thus, in *Mars Hill,* the Commission considered the 57/43 (debt/equity) capital structure of General Waterworks, but determined that because General Waterworks was clearly attempting to shift to a 60/40 capital structure (and that ratepayers had been incurring higher debt costs as a result) that structure was the *"appropriate"* one to use for cost of capital determination.

The line between the use of a *"hypothetical"* capital structure and an *"actual"* one constructed taking into account anticipated changes is a blurred one. Depending upon the degree of certainty which prospective changes present,[44] either a *"near term actual pro forma"* or a *"hypothetical"* capital structure may be found, and either may, in proper circumstances, be within the Commission's discretion. As we suggested in *Mars Hill,* our approval in *New England Telephone* of two *"well-recognized"* situations in which a capital structure other than the actual test-year one may be used was neither comprehensive nor exclusive. There may be *"case*[s which] *do not fit precisely into either category,"* 397 A. 2d 583, yet in which the use of other than the actual capital structure may represent a reasonable exercise of the Commission's expert judgment supported by the record.

In the present case, use of a 35% equity ratio, though premised on probably future trends in Central Maine Power's financing, must be considered hypothetical. Staff witness David Kosh presented testimony concerning both the Company's pro forma capital structure and a *"desirable"* one containing a lower equity figure. After presenting his pro forma study, he noted that *". . . it is clear that the fair rate of*

[44] For this reason, the *"facts which with certainty will gain life in the future"* found in *Mars Hill* place it closer to an *actual* capital structure than might be the case in which the predicted changes are less assured.

return should be based on the appropriate capital structure as opposed to the actual one." (emphasis added). The Decree reviewed both structures, and concluded that the *"desirable"* one containing 35% equity was *"appropriate and should be used. . . ."*

The question remaining, therefore, is whether the Commission's determination is *"reasonable in result and methodology and supported by substantial evidence." New England Telephone, supra,* at 34.

The Commission's use of a 35 percent common equity ratio was based on its conclusion that while CMP's actual year-end equity ratio has gradually increased, from 30.64 percent in 1974 to 33.95 percent in 1977, that trend will cease in the short-term future.

The testimony of Mr. Kosh, president of a utility consulting firm, is the primary basis of the Commission's finding in this regard. Kosh presented a study of the capital structures of 64 original cost electric utilities, concluding that their average year-end equity ratio in 1976 was 34.1 percent; at year-end in 1977, 35.5 percent. He concluded, in part on the basis of this study, that CMP's pro forma 36.6 percent equity ratio was *"above the zone of reasonableness,"* and advocated the 35.0 percent figure subsequently accepted.

Aside from considerations of economy to ratepayers, however, the Commission is bound to give weight to the issue of safety to investors. With this in mind, Mr. Kosh studied the safety of a capital structure with a 35 percent equity ratio, and concluded that it could withstand a decline in earnings so severe as to have only a 1-in-100 chance of occurrence, and still produce an after-tax interest coverage of over two times. This study, based on historical data concerning CMP's rate earned on total capital during the period 1969-1977, led Mr. Kosh to conclude:

Thus, in my opinion, a 35% equity ratio for Central

Maine Power would lie at the upper end of the range of reasonableness. If anything, then, Central Maine Power's equity ratio which is in excess of 35% is somewhat above the upper end of the range of reasonableness.

On cross-examination, counsel for Central Maine Power suggested that the periods 1970-77 and 1972-77 be used in the safety study, as they had produced the greatest fluctuations in return for Central Maine Power from 1960-1977. Recomputing the study, applying the same 1-in-100 disaster test, the after tax coverages were 1.98 times for 1970-77 and 1.97 times for 1972-77. The Commission accepted this study as evidence of the safety of a 35% equity ratio.

Central Maine Power does not contest the Commission's finding that a 35 percent equity ratio is safe, as Mr. Kosh's studies indicate. Likewise it does not (and logically cannot) contest the fact that a 36.6 percent (or 36.15 percent) equity ratio is more expensive to ratepayers. It relies instead upon the claim that the capital structure of a utility is a function of management, *citing In Re Stratton Water Co. Proposed Increase for Rates,* Me., 383 A. 2d 1373, 1377 (1978), and that the Commission lacked sufficient evidence to support its finding that the Company's pro forma 36.6 percent equity ratio was *unreasonable.*

To this end, it also attacks the probity of the evidence relied upon by the Commission. Mr. Kosh, the Company contends, compared Central Maine Power's capital structure pro forma to year-end *1978* with the capital structures of 64 electric companies in *1976*. At year end 1976, the Company claims, its common equity ratio was 32.5 percent, placing it in the mainstream of Kosh's figures for that date.[45] However, the Company continues, testimony of its witnesses established an industry-wide increase in common equity ratio after 1976, so that at year-end 1977 the breakdown of Kosh's 64 companies produced an *average* common equity ratio of 35.5 percent, *above* his range of reasonableness.[46] Kosh's figures, Central Maine argues, do not reflect market realities. Citing the American Bar Association's *Annual Report of the Section of Public Utility Law* (1978) at 236, they point to a year-end 1977 average of 36.3 percent common equity, the highest since 1968.

[45] As of 1976, Kosh testified, the common equity ratios for companies in his study broke down as follows:

26 Companies: 35% or above
30 Companies: 30% to 35%
8 Companies: Below 30%

The Commission responds to the citation of the American Bar Association Section *Report* by noting that short-term debt is excluded from the figures presented there, a condition which tends to inflate the equity ratio. If the companies in that report had short-term debt relatively comparable to Central Maine Power, the Commission notes, average equity ratio at year-end 1977 would have been 35.2 percent — far closer to the 35.0 percent advocated by Kosh and accepted by the Commission than the 36.6 percent (adjusted to 36.15 percent) suggested by the Company.

This plethora of conflicting evidence illustrates the wisdom of our long-standing policy of according the Commission considerable deference in the realm of economic fact-finding.[47] This Court possesses neither the resources, the expertise, nor the inclination to act as a *"super-commission."* We cannot substitute our judgment of the economic facts presented for that of the Commission. We cannot say, on the basis of the

[46] The 1977 breakdown, according to Central Maine Power, was as follows:

35 Companies: 35% or above (average 38%)
25 Companies: 30% to 35%
4 Companies: Below 30%

[47] *See, e.g., New England Tel. & Tel. Co. v. Public Utilities Commission, supra,* 390 A. 2d at 37-38; *Casco Bay Lines v. Public Utilities Commission, supra,* 390 A. 2d at 490; and cases cited therein.

evidence presented, that the Commission could not reasonably conclude that a 35 percent equity ratio was proper. The challenges to Kosh's testimony reviewed here were made known to the Commission; it would not be unreasonable for them to reject them as unpersuasive. Assuming *arguendo* that the upper end of Kosh's *"range of reasonableness"* should have been, e.g., 37 percent rather than roughly 35 percent, that would not prevent the Commission from concluding that a 35 percent equity ratio was proper. Many other variables bearing on Central Maine Power's peculiar case had to be considered than could neatly be settled by evidence of industry averages alone. It would not be unreasonable for the Commission to conclude, for example, that equity ratios had peaked and would decline in the near future, or that Central Maine's financing plans mandated a lower ratio than might prevail on the average. Such are the judgments entrusted to the Commission. The requirement that they be supported by substantial evidence does not demand that they be absolutely uncontested.

The reasonableness of using a given ratio of capital structure cannot be judged in the abstract, but must be compared and contrasted with alternatives. Indeed, the very process of determining what is *"reasonable"* is one of selecting from among competing alternatives the choice which presents the optimal combination of necessary qualities. Thus, while an equity ratio of X may present greater economy to ratepayers, it is an unreasonable choice if it does so at the expense of safety to investors. Conversely, a higher equity ratio of Y could be exceedingly attractive to investors, but at inordinate cost to the ratepayers, and would thus be unreasonable.

Ratemaking is an inexact science, fraught with the dangers which accompany all processes of prediction, economic or otherwise. Accordingly, there must be said to be theoretically a *range* of reasonableness in such matters, rather than an exclusive choice. *Central Maine Power v. Public Utilities Commission,* Me., 382 A. 2d 302 (1978). That range may be said to parallel the Commission's discretion, and it is accordingly their right to choose from among alternatives, all arguably within the range of reasonableness, that one which is *most* reasonable, i.e., that one which presents the optimal combination of economy and safety. That is what we anticipated in *New England Telephone, supra,* when we approved use of a hypothetical capital structure by which *"rates . . .* [could be] *determined on the basis of more a reasonable and less expensive capital structure."* 390 A. 2d at 39 (Emphasis added).

In the present case the Commission chose a 35 percent equity ratio — near the upper end of the *"zone of reasonableness"* constructed by staff witness Kosh. It did so on the basis of substantial evidence. Among the factors considered were prevailing ratios in comparable utilities; historical trends in Central Maine Power's financing; its announced intentions with respect to capital additions; and the impact of a severe earnings decline on a structure with a 35 percent equity ratio.

The Commission was *not* required to show that Central Maine Power's pro forma capital structure was unreasonable in any *absolute* sense, but only in comparison to available alternatives. Where substantial evidence supports the Commission's findings that a lower equity ratio offers greater economy to ratepayers and sufficient safety to investors, it is clearly more reasonable. In selecting from among the choices presented by the range of reasonable alternatives, it acted reasonably.

The Company relies heavily on its claim that *"the function of the Commission with respect to capital structure* 'is one of control and not management'," citing *In Re Stratton Water Company Proposed Increase In Rates, supra.* The quoted portion is excepted from a broad statement of principles concerning managerial discretion in general; the Company here seeks to extend it beyond its limitations.

Stratton presented a rather peculiar fact situation. We

there said only that management was entitled to have a note it held endorsed and exchanged for stock (thus transferring debt capital to equity capital) rather than discharged, since cancellation would have *altered* Stratton's capital structure *"in such a way as to lessen* [its] *fair rate of return." Id.* Management, we concluded, could properly choose to protect its right to a return, rather than provide a windfall to ratepayers. Finding such judgments to be a prerogative of management is a far cry from saying that as respects the prediction of future capital structure, requiring assessment of enormously complex contingencies — many beyond the control of management — managerial judgments must be deferred to. To do so, as the Commission warns, could be to force the Commission to abdicate its supervisory responsibility in this area:

> *Central Maine's equity ratio has slowly increased each year since 1974 in relatively small amounts and the Commission noted its concern about this trend.* [. . .] *Central Maine suggests that the mere fact that the 36.6% or the 36.2% ratio is close to 35% precludes the Commission from disturbing this* "function of management."
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> *If, indeed, the Commission cannot use a 35% hypothetical equity ratio because it is too close to the* "actual" *36.2% equity ratio, that would, perforce, imply that a 36.2% equity ratio produces* "just and reasonable" *rates. The implication is clear. Under such reasoning the Commission would not have regulatory control over companies as long as the equity ratio rises by small increments.*

It is not a proper *"function of management"* to choose excessive safety at the cost of higher rates.[48] Central Maine has

[48] As the District of Columbia Public Service Commission has held:

> [w]*hile we clearly recognize that the composition of the capital structure is a matter for the utility's management to decide,*

not, in its briefs to this Court, contested the validity of Mr. Kosh's study demonstrating the coverages produced with a 35 percent equity ratio in the face of even a severe earnings decline. If a 35 percent ratio is safe, is obviously more economical to ratepayers, and is otherwise found reasonable by the Commission, we cannot say that it was erroneous.

4. Land Held For Future Use Issue

The remaining issue with respect to Central Maine Power's revenue requirements is the Commission's treatment of the utility's Land Held for Future Use (LHFU) and Investments in Joint Corporate Projects (IJCP) accounts. The Commission's action as to this issue is contested by the Consumer Action Coalition, while Central Maine Power joins with the Commission as an appellee.

In its original filings in this case Central Maine Power proposed to conclude in its rate base all of the property held in its LHFU and its IJCP accounts. The Commission excluded two parcels of land, allocable to these accounts, located in Stockton Springs and in Richmond, Maine. The Commission determined that Central Maine Power had not demonstrated

> *and that a utility has a right to maintain a low debt ratio for its own purposes, we also perceive that it is our duty in ratemaking proceedings to ignore any capital structure which is not conducive to the lowest cost of service that is consistent with a sound financial posture.*

Re Chesapeake & Potomac Tel. Co., 57 P.U.R. 3d 1, 39 (D.C.P.S.C. 1964), *aff'd. sub. nom. Telephone Users Association, Inc. v. Public Service Comm. of the District of Columbia*, 271 F.S. 393 (D.D.C. 1967), *aff'd.*, No. 21, 318 (unreported) (D.C. Cir. Oct. 21, 1968), *cert. den.*, 395 U.S. 910, 89 S. Ct. 1742, 23 L.Ed. 2d 223, *rehearing den.*, 395 U.S. 987, 89 S. Ct. 2127, 23 L.Ed. 2d 226 (1969).

any *"definite plan to use these two properties at any point in the foreseeable future."*[49]

The Commission included 81 percent of Central Maine Power's property on Sears Island, finding the Company had demonstrated a sufficiently definite plan for its use as a site for a coal-fired generating plant.[50] Central Maine Power has not appealed from these exclusions or adjustments.

The Commission made no explicit findings as to any of the other properties included in the two accounts. Instead, finding no record evidence of either the existence or non-existence of definite plans for the properties, the Commission concluded that they should be included in rate base.[51] The Consumer Action Coalition now contends that the Commission erred by including these properties in the absence of an affirmative showing by Central Maine Power of a definite plan for their proposed use.

We deny the Coalition's appeal.

A review of the record discloses that the only issues raised in proceedings below regarding property held for future use

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[49] Stockton Springs was characterized as a *"future/alternative site for steam generation"* whose earliest possible operational date was in the late 1980's. Richmond was considered a possible site for a nuclear plant. The earliest date for putting this land into service was said to be 1991, although Central Maine Power admitting that target was becoming less realistic. The Commission concluded it would not *"burden ratepayers for an indefinite period with paying a return on Company assets which confer no immediate benefit on and provide no guarantee of future benefit to Central Maine's ratepayers."*

[50] Only 81 percent of the Sears Island property was included in rate base since that was the percentage of the plant which would ultimately be owned by Central Maine and placed in service for its ratepayers' benefit.

[51] The Commission did, however, place Central Maine Power and other utilities on notice that in the future they would bear the burden of showing affirmatively the existence of a definite plan of proposed use for each property in the two accounts.

which was ultimately included in rate base concerned the Sears Island property.[52] The Coalition now concedes the propriety of Commission action with respect to Sears Island, and challenges only its determination to include, without evidence of specific development plans, some forty-three relatively small items representing an average year-end investment of $657,000 out of a total rate base of $514,032,000.

The failure of the Coalition to raise before the Commission[53] the issue now presented to this Court — the proper allocation of the burden of proof with regard to inclusion of such properties — precludes it from advancing it here. As we have repeatedly held with respect to trial court procedure:

> *It is an acknowledged principle, and one generally followed by this Court as necessary to a sound appellate practice, than an issue raised for the first time at the appellate stage will be denied cognizance in the appellate review of the case. Walsh v. City of Brewer,* Me., 315 A. 2d 200, 209 (1974) (citations omitted).

As we more recently noted, the principle applies with equal force to proceedings before the Public Utilities Commission:

> *A reviewing court usurps the agency's function when it sets aside the administrative determination upon a ground not theretofore presented and deprives the Commission of an opportunity to consider the matter, make its ruling, and state the reasons for its action. Casco Bay Lines v. Public Utilities Commission,* Me., 390 A. 2d

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[52] The Commission Staff had recommended an adjustment be made for the Richmond property similar to that made as to Sears Island. The Commission exclusion of the Richmond property in toto, however, removes that issue from contention.

[53] At the close of hearings briefs were filed in which the Coalition advanced a *policy* argument urging the Commission to disallow *all* of the property held for future use for lack of definite plans for use. No mention was made, however, of the *legal* argument now raised concerning a utility's burden of proof as to such properties.

483, 487 (1978) (per curiam), *quoting Unemployment Compensation Commission of Alaska v. Aragon,* 329 U.S. 143, 155, 67 S. Ct. 245, 251, 91 L. Ed. 136 (1946).

Neither can the Coalition contend that the mere existence of the properties, and the necessity of some action either including or excluding them from rate base, itself raises the burden of proof issue. Decisions of this Court as well as of the Commission and other regulatory bodies makes clear that merely filing for a rate increase does not automatically place a burden on the utility with respect to every item of every account. While the utility has the burden of establishing the overall justness and reasonableness of its proposed rates, absent some prior notice it cannot be called upon to account for every allocation made, property purchased, or other action taken. *Central Maine Power Co. v. Public Utilities Commission,* 156 Me. 295, 325, 163 A. 2d 762, 778 (1960); *See also Re Consumers Power Co.,* 14 P.U.R. 4th 1 (Mich. P.S.C. 1976); *Re Chesapeake & Potomac Telephone Co.,* 57 P.U.R. 3d 1 (D.C. P.S.C. 1964).

This issue not having been passed upon by the Commission, it must be denied appellate cognizance.

III.

RATE DESIGN

1. Uniform Percentage Increase

The design among rates, as well as the revenue level they will generate, is a facet of Commission ratemaking. *Central Maine Power v. Public Utilities Commission,* Me., 392 A. 2d 302, 324 (1978). In the present case rate design issues occupied a substantial portion of the proceedings below. All of the intervenors were primarily concerned with rate design, and Central Maine's proposed increase envisioned not only increased revenues but a realignment of the relative positions

of the rate classes such as would increase the rates of some classes more than others. It is the Commission's action in rejecting this proposed realignment which serves as the basis for appeal with respect to the Commission's rate design decisions challenged here.

Central Maine Power, on the basis of a cost-of-service study produced by its Director of Rates, Mr. Frederick Anderson (*"the Anderson study"*), filed proposed rates designed to increase overall revenues by approximately 12.5 percent, with increases in individual rate classes ranging from 3.7 percent to 17 percent. The Company argued that such disparate increases were necessary to decrease the existing differential among those customer groups producing a rate of return close to or above the overall return, and those producing a return below the overall average.

The Anderson study was based on a 1977 test year using eight months actual and four months estimated data, later recomputed on the basis of actual 1977 test year data. The study used a *"coincident peak method"* for allocating to the various customer classes certain demand costs associated with power supply. Under this method, costs were allocated to each class based upon its contributions to the single one hour annual system peak.

The Commission rejected the Anderson study, however, and finding no evidence in support of a realignment of classes not based on that study, determined to make no change:

> *We find that the use of the one hour coincident peak method for allocating demand costs is so flawed and yet is so significant in the overall result of the cost of service study that we are unable to rely on the study as a basis for allocating the revenue increase among the various rate classes. Were the* "90% of peak" *method we have found to be fairer to be used, it is conceivable that the returns earned from the various classes would be very different from the figures the Company has presented to us. But we*

have no way of knowing what they would be.

Having rejected the cost of service study as a basis for allocation of the revenue increase, we are left in the position of having to make allocations without the aid of any competent cost evidence. Under these circumstances, we find that the only reasonable and fair result is to require that rates be designed so as to give all classes of service the same percentage increase over total test year revenues.

Intervenor-appellant St. Regis Paper Company (St. Regis) contends that this uniform percentage increase was arbitrary and capricious, not supported by substantial evidence, and erroneous as a matter of law. In particular, it attacks the Commission's rejection of the Anderson study in the absence of an alternative proposal. Central Maine Power, nominally an appellee as to this issue, concurs with St. Regis.

We may initially conclude that the Commission staff's failure to present a direct case on the proper allocation of the revenue increase among the rate classes does not constrict the Commission's freedom of decision. Even the uncontradicted evidence of the utility may be weighed, critically examined, and rejected if deemed necessary. *Maine Water Company v. Public Utilities Commission,* Me., 388 A. 2d 493, 496 (1978). Moreover, our decision in *Maine Motor Rate Bureau,* Me., 357 A. 2d 518 (1976) does not require the Commission to accept an uncontroverted allocation study if the evidence supports its rejection. 357 A. 2d at 528. Whether the Commission's rejection of the Anderson study and imposition of a uniform increase was reasonable and supported by *"substantial evidence"* is thus the sole basis of the alleged error.

Faced with a similar challenge to the Commission's rejection of a utility's proposed rate design, we concluded in *New England Telephone, supra,* that the issue need not be decided in view of our disposition of other issues presented by an appeal.

We reach the same conclusion here.

Our decisions respecting the Commission's treatment of taxes deferred by accelerated depreciation and its exclusion from rate base of the employee discount will substantially affect the ultimate revenue level allowed Central Maine, which will be required to file proposed rate schedules to generate this new level. Central Maine may choose to seek a uniform percentage increase, or to present revised studies supporting realignment; the Commission may find such studies persuasive, or may otherwise accept some form of realignment. We cannot know now the outcome of such contingencies. Nothing we might say now respecting the Commission's action as to this issue would necessarily have force in light of future events. Accordingly, we decline to express any opinion as to the propriety of the Commission's action on this issue.

2. Residential Rate Design

A. Customer Charge

Establishing cost of service for rate design is a complex process. The methodology employed here by Central Maine, and adopted by the Commission as to this issue, entails three steps. All of Central Maine Power's costs are first designated according to their *"function"*, i.e., power supply, transmission, subtransmission or distribution. Each of these functionalized costs is then *"classified"* according to its demand, energy or customer components. Finally, all costs are *"allocated"* among the various customer classes by use of allocation factors, which are derived by various methods depending upon the function and classification of the cost.[54]

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[54] Demand-related costs, for example, are allocated by several different methods, one of which is the *"coincident peak"* method. It was the Commission's conclusion that such allocation produced an unrepresentative cost of service which led to its rejection of the Anderson study and the imposition of a uniform percentage in-

In the proceeding below, as a complement to its decision to discard the existing *"declining block rate"* structure[55] and impose a flat energy rate, the Commission established a $5.70 monthly customer charge. The Consumer Coalition and the Natural Resources Council of Maine, intervenors below, challenge that action. Specifically, they dispute the classification of certain parts of the distribution system — sometimes called the *"minimum"* or *"phantom"* distribution system — to customer costs. These costs, they argue, are properly classified to demand rather than customer costs, a revision which they contend would lower the monthly customer charge from $5.70 to $3.15.

The Commission argues that while the intervenors' proposed design — which seeks to track as closely as possible the *marginal* energy and demand costs of producing electricity — may have merit, it faced the *"different problem"* of producing an equitable rate structure once declining block rates had been abolished.

Prior to the rate proceeding presented for review here, Central Maine Power charged each residential customer $3.40 per month for customer costs. This *"minimum bill"* included the right to use 25 kilowatt hours of energy at no additional charge. In its original filings, Central Maine proposed increasing that customer charge to $4.00 and providing no *"free"* energy at all. At the same time, the Company observed that while its actual customer cost was *"considerably more"* per month, the difference would be recovered in the first energy blocks of their proposed declining block-rates.[56]

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crease. The dispute as to the present issue concerns the *classification* of certain costs as customer-related.

[55] *See Central Maine Power Company v. Public Utilities Commission*, Me., 382 A. 2d 302, 327-28 (1978) for a discussion of this variety of rate structure.

[56] In its Decree the Commission explained this phenomenon:

> *To the extent that the actual customer cost exceeds the customer charge, the difference has apparently been recovered in the first few blocks of the declining block rate. This means that the charge for a kilowatt hour in those blocks includes a charge for the energy itself; some charge for demand, as discussed above* [see note 57 *post.*]; *and a charge for that portion of the customer cost which is not actually charged to each customer individually. Thus, as a customer's energy use progresses through the various blocks, the customer is helping to pay the actual customer cost of other customers' as well as his own. The more energy a customer buys, the more of these costs he pays.*

When the Commission suggested the use of a flat energy rate, Central Maine Power witness Anderson stated that in that event the customer charge should be $5.68.

The Commission ultimately found that *"if there ever was a cost justification for declining blocks, that justification no longer applies to residential customers, and, therefore, . . . the declining block structure should be eliminated from the residential class rate."*[57]

The Commission, therefore, determined to accept Central Maine's customer cost figure of $5.68, rounded to $5.70, as the residential customer charge to be assessed in connection with the new schedule employing flat energy rates.

There is little dispute over the definition of what costs should be classified as a customer cost. The Company defines customer costs as

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[57] The Commission rejected the two traditional justifications for declining block rates, namely, (1) lower use energy blocks recovered the customer costs not included *"up front"* in the customer charge, and (2) higher-use customers have been thought to have less demand (judging by system peak) than lower-use customers, and demand costs were assessed in the lower-use energy blocks so that lower-use customers would pay their proportionate share. The only remaining justification, the Commission concluded, would be that the energy charge included some customer costs. Finding it inappropriate, as noted in n.56, *supra*, to allow intra-class subsidization of customer costs, the Commission chose to assess a higher *"up front"* customer charge in order to move to a flat-rate energy charge. No party to this appeal contests the Commission's decision to do away with the declining block structure.

> . . . *fixed costs which vary on a total company basis with the number of customers serviced and . . . not . . . with demand (KW) and energy (kwh) consumption. In addition, these costs have no time dimension at all.*

Or, as the Commission Decree paraphrases it, *"costs that vary with the number of customers in the rate class, regardless of the energy or demand use."* The Consumer Coalition seeks to refine the definition somewhat by citing Professor James Bonbright to the effect that the customer charge should be composed only of those costs which are *clearly* allocable as such and which vary *directly* with the number of customers regardless of consumption. Bonbright, *Principles of Public Utility Rates,* 347-348 (1969). These nuances are of some significance to the intervenor's arguments.

In any event, the major dispute focuses upon determining which costs meet this general definition and should thus be included in the customer charge. No party disputes inclusion of such items as meters and meter reading, billing and customer service costs. What is hotly contested is inclusion of a *"minimum distribution system"*, consisting, according to the Commission, of *"a minimum amount of poles and wires needed, on average, to connect a residential customer to the Company's distribution system."*

In its Decree the Commission quoted Professor Bonbright, *supra,* at some length as to the propriety of including the minimum distribution system costs in customer costs:

> *But the really controversial aspect of customer-cost imputation arises because of the cost analyst's frequent practice of including, not just those costs that can be definitely earmarked as incurred for the benefit of specific customers but also a substantial fraction of the annual maintenance and capital costs of the secondary (low-voltage) distribution system — a fraction equal to*

> *the estimated annual costs of a hypothetical system of minimum capacity. The minimum capacity is sometimes determined by the smallest sizes of conductors deemed adequate to maintain voltage and to keep from falling of their own weight. In any case, the annual costs of this phantom, minimum-sized distribution system are treated as customer costs and are deducted from the annual costs of the existing system, only the balance being included among those demand-related costs to be mentioned in the following section. Their inclusion among the customer costs is defended on the ground that, since they vary directly with the area of the distribution system (or else with the lengths of the distribution lines, depending on the type of distribution system), they therefore vary indirectly with the number of customers.*
>
> *What this last-named cost imputation overlooks, of course, is the very weak correllation between the area (or the mileage) of a distribution system and the number of customers served by this system. For it makes no allowance for the density factor (customers per linear mile or per square mile). Indeed, if the company's entire service area stays fixed, an increase in the number of customers does not necessarily betoken any increase whatever in the costs of a minimum-sized distribution system.*
>
> *While, for the reason just suggested, the inclusion of the costs of a minimum-sized distribution system among the customer-related costs seems to be clearly indefensible, its exclusion from the demand-related costs stands on much firmer ground. For this exclusion makes more plausible the assumption that the remaining cost of the secondary distribution system is a cost which varies continuously (and, perhaps, even more or less directly) with the maximum demand imposed on this system as measured by peak load.* Bonbright, *Principles of Public Utility Rates, supra,* at 347-348 (1961).

While recognizing the difficulties of properly allocating the minimum distribution system costs, the Commission found inclusion of such costs as customer costs to be the most reasonable solution, saying:

> *We find that the most cost-related rate structure for the residential class is one that recovers the full customer cost in the customer charge and the demand and energy costs in a uniform charge for every kilowatt-hour consumer. We find that there is no justification for continuing to use a declining block rate structure for this class. We direct Central Maine to file a residential rate with a minimum customer charge of $5.70 and a flat energy charge designed to generate the necessary revenues for the residential class.*

Challenging this action, the Consumer Coalition points to the same passage by Professor Bonbright as authority for the proposition that these costs (of the minimum distribution system) are basically unallocable according to the usual standards, and hence must be allocated according to the policy goals the Commission seeks to attain. Instead of doing so, the Coalition charges, the Commission made the purely conclusory statement that allocation to customer costs *"is reasonable,"* while providing no supporting findings. Such action, it argues, is arbitrary and contrary to expressions of policy contained in the Commission's decrees and in state and federal legislation. The Natural Resources Council joins in this argument, and notes particularly that Professor Bonbright's conclusion that the lesser of two evils was to include the minimum distribution system costs in customer costs was made in the context of an electric industry with *decreasing* marginal costs, a situation which has since been reversed. Facing the same issue today, the Council urges, Bonbright would have supported allocating costs of the minimum distribution system to the energy charge, to help achieve marginal-cost based rates. The Commission, in the Council's

view, eliminated the declining block structure because it discriminated in favor of electric space heating customers, then inexplicably perpetuated that discrimination by raising the customer charge.[58] By accepting Central Maine Power's cost-of-service study figure for actual customer charges, the Council says, the Commission erroneously assumed it would be left with actual energy charges and therefore appropriate price signals. In fact, they argue, the energy charge has been priced below the Company's incremental cost of providing service, thus moving away from cost-based rates. Now, the Council insists, the energy charge will be whatever revenue requirements dictate, irrespective of any relationship between that charge and the true incremental cost of providing service. *"Appropriate price signals"* do not result, since the customer charge affects only the choice whether to take service, and does not affect consumption patterns.

A redesign of residential rates along the lines suggested by the Consumer Coalition and the Natural Resources Council is

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[58] The Council's brief presented the following illustration of its point:

> *Mr. Thurlow, President of the Company, estimated that the average electric space heater uses 15 to 20,000 kwh annually. (App. 136-137).* [But see, n. *supra.*] *Assuming a winter-month usage of 3,000 Kwh for such a customer, his total bill for that month would be (3000 x 2.19¢ plus $5.70 customer charge) $71.58 (plus fuel for generation charges). (App. 280). His resulting cost would be 2.386¢ per Kwh. A typical residential ratepayer using 600 Kwh that same month would have a total bill of (600 x 2.19¢ plus $5.70) $18.88 or 3.146 per Kwh. Had he conserved and only used 400 Kwh, his bill would be $14.84 or 3.621¢ per Kwh. Under the discriminatory and allegedly discarded declining block rate, the 3,000 Kwh customer would have paid $62.63 for an average Kwh cost of 2,088; the 600 Kwh customer $23.81 or 3.968. In this particular instance, under the new rates, the discrimination would be reduced but remain substantial; at very low use levels, the discrimination obviously will have increased inasmuch as the $5.70 charge is much higher than the $3.40 charge for the first 25 Kwh.*

not without merit. The path chosen by the Commission is not without faults. According the Commission due deference in light of its legislative function and expertise, however, we find the result reached and the methodology used to be reasonable, and the rate design to be supported by substantial evidence. *Mars Hill, supra,* at 588.

Marginal cost pricing, as a rate design methodology, attempts to reflect a utility's incremental (or decremental) cost of providing one more (or one less) unit of electricity at a given moment. Although in the forefront of many contemporary reevaluations of electric rate structures, it is not without its difficulties, most notably that "[t]*here are enormous definitional problems in determining what is and what is not a marginal cost.*" A. C. Aman, Jr. & G. S. Howard, "*Natural Gas and Electric Utility Rate Reform: Taxation Through Ratemaking?*" 28 *Hastings L. J.* 1085, 1090 (1977). Before the Commission, marginal costs were defined variously as the cost of producing an additional unit of output and as the first derivative of average cost. Three different calculations of marginal costs, each showing substantially different results, were presented the Commission. It was reasonable for the Commission to decline to attempt implementation of marginal rates, given such difficulties.[59]

Recovery of fixed customer costs, including those attributable to the minimum distribution system, through a $5.70

[59] In this respect the rejection of a residential rate structure such as that proposed by the Coalition or the Council is similar to the Commission action taken in the 1978 *Central Maine* case, *supra,* 382 A. 2d 302, 326-28. There, intervenors had urged the Commission to discard the "*declining block*" system, and it had declined to, principally for lack of adequate information from which to fashion a substitute design. Here, the Commission abolished declining blocks, but declined to go further and implement marginal-cost based rates. Our rationale in upholding the Commission action there applies with equal force in the present case.

customer charge was also reasonable, and supported by substantial evidence.

No party contests Central Maine's establishment of the $5.68 composite customer cost figure, nor disputes that some of that cost was once "*hidden*" in the declining block structure. As noted, the focus of dispute is upon proper classification of those costs, particularly those of the minimum distribution system. The Commission, having opted for a flat energy rate, faced the option of classifying such costs to the energy charge (raising the price per kilowatt hour) or segregating them in a distinct charge. The testimony of Mr. Anderson was that elimination of the customer charge and classification of those costs to energy would require an energy charge of 3.16 cents per kilowatt hour, while use of a $5.68 customer charge would allow the energy charge to be set a full 1 cent lower. Central Maine Power presented the following chart illustrating the cross-subsidization which would result from imbedding customer costs in the energy charge.

	CUSTOMER COST		REVENUE EXCESS
KWH	*Actual*	*Recovered*	*(Deficiency)*
0	$5.68	$ 0	(5.68)
25	5.68	0.25	(5.43)
100	5.68	1.00	(4.68)
500	5.68	5.00	(0.68)
1000	5.68	10.00	4.32
2000	5.68	20.00	14.32
5000	5.68	50.00	44.32
10000	5.68	100.00	94.32

Obviously, high-use customers would be (unknowingly, in most cases) subsidizing low-use customers. While conservation of electricity is an undisputed goal, it cannot be the justification for discrimination of this sort. So, too, although flat rates for energy are perhaps less effective in encouraging

conservation that some other methods might be,[60] they are reasonable when used in conjunction with a customer charge which properly assesses the cost of being tied to the electric service system.

Substantial evidence supports the Commission classification of minimum distribution system costs to the customer charge. The NARUC Cost Allocation Manual[61] recognizes two methods of determining the customer cost component of distribution system plant: the minimum size and minimum intercept methods. Central Maine Power used the minimum size method, which entails classification of a minimum distribution system to customer costs.[62] Significantly, a Consumer Coalition witness conceded on cross-examination that his proposal to classify distribution plant cost to demand related cost was not recognized in the *NARUC Manual,* while use of the minimum size method was.

The Commission was faced with the task of allocating what it termed *"basically unallocable"* costs. The testimony and evidence supporting classification of the minimum distribution system to customer costs was substantial. The *NARUC Manual* approves such a choice, and not the intervenors' alternative. Professor Bonbright criticized inclusion in customer costs, but rejected inclusion in demand costs with at least equal fervor. Though the costs of the minimum distribution system vary, at best, only indirectly with the number of customers served, they do not vary *at all* with demand or energy, leaving the Commission only a Hobson's choice with respect to the allocation of these costs.

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[60] *See, e.g.,* the discussion in 28 *Hastings Law J.* 1085, 1088-1113 (1977), supra.

[61] Doran, Hoppe, Koger & Lindsay, *NARUC Electric Utility Cost Allocation Manual* (1973), NARUC is an acronym for the National Association of Regulatory Utility Commissioners.

[62] The minimum intercept method, based upon average installed book cost of plant items, is considered somewhat inaccurate in times of inflation. *NARUC Manual* at 56.

Facing this dilemna, the Commission was entitled to exercise reasonable discretion in selecting a methodology to account for these costs. Classifying them to the customer charge, in order to implement flat energy rates without exacerbating existing cross-subdization, was a reasonable exercise of that discretion. The use of averaging to produce a flat energy charge which will produce the necessary residential revenue requirement, while perhaps lacking in precision, is a reasonable technique producing a reasonable result. Adoption of the policy urged by the intervenors of classifying the costs of the minimum distribution system to the energy (demand) charge would be equally imperfect, and Commission discretion must, therefore, carry the day. *New England Telephone, supra,* at 59 (1978).

B. Seasonal Rates

The Natural Resources Council of Maine, supported by testimony of its expert witness, Dr. Richard S. Bower, proposed to the Commission that two different residential rates be implemented: a higher one for the November through February heating season, and a lower one for the remainder of the year. The Commission rejected the proposed differential, and the Natural Resources Council appeals.

Relying on a marginal cost analysis conducted for Central Maine Power by the National Energy Research Association (NERA), Doctor Bower concluded that the marginal cost of service varied by season,[63] and that a seasonally-differentiated rate was the proper method of reflecting that differential and producing cost-based rates. Doctor Bower's methdology for determining marginal costs per kilowatt-hour for

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[63] Doctor Bower's calculations produced a seasonal difference in costs per Kwh of more than 2 cents, finding costs to be 6.42 cents/Kwh in winter and 4.04 cents/Kwh in non-heating season.

each season was straight-forward. He adopted the NERA study's calculations as to the marginal demand-related unit costs, as to marginal energy costs, and as to allocation factors for each pricing period (November-February and March-October). Using information on residential load and total residential energy sales, Doctor Bower produced marginal costs per kilowatt-hour for each pricing period, from which in turn he developed his seasonally differentiated residential rates.[64]

The Commission agreed that, *on average,* providing service is more costly during the winter months. It concluded, however, that it lacked sufficient information to establish seasonally differentiated rates which would be equitable in individual cases. The NERA study on which Doctor Bower relied did not attempt to break down the variations in marginal costs *during* the broad winter pricing period. Rather, it computed only *average* costs which are subject to considerable fluctuation depending upon the day of the week and the time of day. Consequently, although on average the costs of producing electricity during the heating season are higher, the Commission recognized that at many hours during that season the costs may actually be lower than during some hours of the non-heating season. Without this more detailed breakdown of costs, the Commission was concerned that the seasonal rate could be a shotgun approach, and declined to adopt it:

> *We reject Dr. Bower's proposed seasonal rate because we find that there is a substantial likelihood that many customers would be penalized in excess of the costs they actually impose on the system. Rates that vary by season, in conjunction with rates that vary by time-of-day, may*

[64] Doctor Bower's study yielded a winter rate with a monthly customer charge of $4.00 and an energy charge of 4.46 cents per kilowatt-hour, and a non-heating season rate with the same $4.00 customer charge and an energy charge of 2.58 cents per kilowatt-hour.

> *be the best way to reflect the actual cost of service. However, there are certainly many hours during the winter months which should properly be characterized as off-peak hours. Unless and until time-of-day rates are available for all customers, a seasonal rate would unfairly charge on-peak rates for a considerable amount of off-peak use.*

Given more information, the Commission now argues, seasonal rates might be an appropriate method of reflecting cost differences. However, it continues, on the state of the record here, the Commission acted within its discretion in refusing to implement a seasonal rate.

The Natural Resources Council assails the Commission rationale, contending that the NERA study was far more comprehensive than the Commission admits, producing costs measured both seasonally and on an on-peak and off-peak daily basis, year round. Recognizing that it suffers from the limitation of being unable to precisely monitor the specific performance of specific customers as an ideal time-of-use rate structure would, the Council urges that the same limitation applies to the flat-rate structure adopted by the Commission, and that the Commission erred in not choosing the structure (i.e., seasonally differentiated) that would have minimized the discrimination the Commission found to be imposed on low and medium residential users in the form of a subsidy to heavy users. Even if, the Council says, the costs are only averages, they do vary seasonally, and the Commission itself has decreed that averages must sometimes be employed where greater precision is unattainable. Further, the principal rationale offered by Central Maine Power on this issue — that a lower summer rate could increase demand at that time, and interfere with scheduled generator maintenance — was considered by NERA in producing its study, and the experience of the Central Vermont Company (an electric utility) with a seasonal differential produced no sug-

gestion of maintenance difficulties. Finally, the Council points to, *inter alia,* the *Maine Electric Rate Reform Act,* 35 M.R.S.A. §§ 91 *et seq.* (1977) and the federal *Public Utility Regulatory Policies Act of 1978* (PURPA), P. L. 95-617, 92 Stat. 3117 (*U.S. Code Cong. & Adm. News,* No. 12, January 1979) as establishing policies mandating implementation of such ratemaking techniques as seasonal differentials. The rejection of Doctor Bower's proposal, the Council concludes, was based on unsupported speculation as to its potential for error, and was arbitrary and capricious.

Once more we are plunged into the thicket of the rate design briar patch. Once more we conclude that the Commission acted within its discretion, with a methodology and result that is reasonable and supported by substantial evidence.

Initially we note that the result — a failure to adopt seasonally differentiated rates — derives some aura of reasonableness from the bare fact that a contrary decision would have been unprecedented. Seasonally differentiated rates have never been implemented in this jurisdiction, and one alleging that the failure to do so is in itself unreasonable shoulders not only the ordinary burden of the appellant but the weight of past practice. While tradition alone will not save unreasonable conduct, the unreasonableness of a historically accepted practice in the circumstances under consideration must be shown. *See Central Maine Power Company v. Public Utilities Commission, supra,* 382 A. 2d 302 at 328, n.39.

Several witnesses testified as to the proper rate design; only Doctor Bower recommended a seasonal rate. Central Maine Power's Anderson rejected a seasonal differential on the basis of the necessity for summer maintenance noted above; we do not find the evidence on that facet of the issue conclusively supportive of either position, nor does it appear that the Commission necessarily assigned any significance to it. Doctor Wilson specifically rejected use of a seasonal differential for several reasons, including the relatively small winter-summer peak differential, the scheduled maintenance problem, and Central Maine Power's responsibilities as part of NEPOOL. In abbreviated form his testimony was that:

> *On the Central Maine Power Company system, I've not made any seasonal differential. That's kind of unusual. Normally, in a situation like this I would recognize a seasonal differential. There are several reasons for not doing it. One, the winter peak and the summer peak tend to be pretty close together with each other.*
>
> • • •
>
> *Moreover . . . there's reason to believe — that the excess capacity during the off peak periods and particularly during the spring and the fall is necessary for planned maintenance anyway . . . there's not so much of that off peak time that it would appear obvious to me that an off peak rate ought to be charged.*
>
> • • •
>
> *Moreover, we've got another complication . . .* [i.e.] *whether or not the rates for the Central Maine system ought to reflect NEPOOL peaks and whether they ought to reflect peaks in Maine. . . . Well, as it turns out, other than the seasonal differential between CMP and NEPOOL the daily loads look pretty much the same. On a daily basis we don't have terribly much in the way of complication as to whether we ought to use CMP or NEPOOL.*
>
> • • •
>
> [G]*iven the fact that the summer peak is nearly as great as the winter peak, given the fact that the off peak periods are needed for system maintenance and given the fact that NEPOOL doesn't have the kind of winter peaks that*

the CMP systems has, I thought that the most direct — certainly the least complex and perhaps the most accurate way of designing rates was to impose no seasonal differential at all.

Doctor Bower referred on several occasions to the experience of Central Vermont Company under a seasonally differentiated rate. As Central Maine points out, however, Central Vermont's winter/summer peak differential has historically been much larger than Central Maine's and as of the 1977 test year was still slightly above Central Maine Power's.[65] The impact of a seasonal rate in leveling the differential could be expected to be far less in the case of Central Maine Power than in the Vermont experience; moreover, the perceived necessity for a leveling would be correspondingly reduced. The Commission's conclusion that the risks of a seasonal rate outweighed the prospective advantages is buttressed by these distinctions between the comparative problems and potential gains of the utilities involved. Perhaps the Commission would have considered the risks it foresaw in a seasonal rate worth undertaking had Central Maine's seasonal differential like Central Vermont's, hovered around 40 percent. We cannot so determine, but we can evaluate the shortcomings of evidence supporting a seasonal rate in determining

[65] Doctor Bower's historic and projected load differentials for Central Maine Power were as follows:

YEAR	WINTER/SUMMER PEAK LOAD DIFFERENTIAL
1960-1964	10.8%
1965-1969	11.2
1970-1974	16.2
1975-1979	22.6
1980-1984	24.0

By comparison, Central Vermont's differentials were: 12.2 in 1961, 40.7 in 1971, 39.1 in 1972. After implementation of a seasonal rate, the differential has been reduced to 30.2 in 1976 and 24.4 in 1977, a level still above Central Maine Power's current differential of approximately 22% to 23%.

whether the Commission's rejection of it was erroneous as a matter of law.

The citation by the Council of state and federal legislation establishing policies variously urging and mandating consideration of more clearly cost-based rate designs and structures does not suggest unlawful Commission action. The Maine Electric Rate Reform Act specifically states that the Commission is *"authorized"* to implement experimental or other reforms *"as* [it] *may determine is appropriate,"* 35 M.R.S.A. § 94. Similarly, the Public Utility Regulatory Policies Act requires state regulatory commissions to *"consider"* such standards as seasonal rates, and determine *"whether or not it is appropriate to implement such* [a] *standard . . ."* § 111(a); *See also H. Conf. Rep.* No. 95-1750. The Act, as the Council concedes, was not signed into law until nearly a month after the Commission's Decree in this case, and allows commissions three years to consider the implementation of the *"standards"* set forth therein. § 111(b). The question, the Council says in its reply brief, is not whether the Commission has violated any specific directive of PURPA, but whether it violated its policy in declining to adopt seasonal rates. On the basis of this record, we cannot find such a violation. The Commission made its decision after hearing conflicting evidence as to the propriety of seasonal rates. In choosing the more conservative path of declining to adopt seasonal rates without further assurances of precision in tracking actual costs, it was faithful to its obligation to make no findings without substantial evidence.

We deny the appeal of the Natural Resources Council of Maine as to this issue.

The entries are:

1. As to Central Maine Power Company: Section 303 appeal denied in part and sustained in part.

Section 305 complaint granted in part and denied in part.
Judgment for defendant on Section 305 complaint as respects the capital structure issue, for plaintiff as respects remaining issues.
Appeal from Superior Court denied as moot.

2. As to Intervenors St. Regis Paper Company, Consumer Action Coalition, and Natural Resources Council of Maine, *et al.:*
Section 303 appeals denied.

Remanded to the Public Utilities Commission for further proceedings consistent with this opinion.

McKusick, C.J., did not sit.
Delahanty, J., did not sit.

Wernick, Archibald, Godfrey, and Nichols, JJ., concurring.

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NOTICE: This opinion is subject to formal revision before publication in the Maine Reporter. Readers are requested to notify the Reporter of Decisions, Box 368, Portland, Me. 04112, of any typographical or other formal errors before the opinion goes to press.

Appendix B.

STATE OF MAINE

PUBLIC UTILITIES COMMISSION

Central Maine Power Company
Re: Proposed Increase in Rates.

F.C. #2332

Kenneth R. Gifford, *et als.* v.
Central Maine Power Company

F.C. #2336

October 13, 1978

GELDER, Chairman; SMITH and CARRIGAN, Commissioners

APPEARANCES: Gerald M. Amero, Esquire, Portland, Maine; Seward B. Brewster, Esquire, Augusta, Maine
For Central Maine Power Company

Wayne R. Crandall, Esquire, Rockand, Maine
For the Martin-Marietta Corporation

Paul A. Fritzsche, Esquire, Lewiston, Maine; V. Louise McCarren, Esquire, Burlington, Vermont
For the Consumer Action Coalition, *et als.*

Mark L. Haley, Esquire, Bath, Maine
For the Maine Oil Dealers Association and 10 Individual Complainants

Roger A. Putnam, Esquire, Portland, Maine
For Scott Paper Company

Edward Lee Rogers, Esquire, Augusta, Maine
For the Natural Resources Council of Maine, Inc., *et als.*

Thomas Schulten, Esquire, Portland, Maine
For St. Regis Paper Company

Frank E. Southard, Jr., Esquire, Augusta, Maine
For Keyes Fibre Company

Joseph Steinberger, Esquire, Augusta, Maine
For Common Cause, *et als.*

Horace S. Libby, Esquire, Augusta, Maine; Frederick S. Samp, Esquire, Augusta, Maine
For the Maine Public Utilities Commission Staff

Introduction

On January 16, 1978, Central Maine Power Company* (hereinafter Central Maine or the Company) initiated this rate proceeding with the Public Utilities Commission (hereinafter the Commission or the P.U.C.) pursuant to 35 M.R.S.A.

* Central Maine is an electrical company as defined by 35 M.R.S.A. § 15(5) and a public utility as defined by 35 M.R.S.A. § 15(3) and is therefore subject to the jurisdiction, control, and regulation of the Public Utilities Commission.

§ 64, by filing a revised schedule of rates M.P.U.C. No. 1** and certain revised rules and regulations which were to become effective on February 15, 1978. The revised rate schedule was designed to increase revenues by 12.5%, or $24,700,000. The Commission docketed the proceeding as F.C. #2332.

After summary investigation, the Commission, by Order dated February 13, 1978, suspended the proposed rates for a period of three months from February 15, 1978. By further Order of the Commission, dated May 12, 1978, the schedules were suspended for an additional five-month period from May 15, 1978.

On January 26, 1978, the Commission implemented its Rule 4A Alternate Hearings Procedure for processing this application. Pursuant to that Order, the Company filed its direct testimony with the Commission. Ten petitions to intervene were received by the Commission by February 7, 1978. By Order of March 2, 1978, the Commission scheduled a pre-

** M.P.U.C. No. 1 consists of:
- Rate A, Sheets 1 and 2, Eighteenth Revision;
- Rate AL, Sheets 1 and 2, Second Revision;
- Rate AL, Sheet 3, First Revision;
- Rate GS-1, Sheets 1 and 2, Third Revision;
- Rate GS-2, Sheets 1 and 2, Third Revision;
- Rate GS-3, Sheets 1 and 2, Second Revision;
- Rate M-3, Sheet 1, Sixth Revision;
- Rate N, Sheet 1, Tenth Revision;
- Rate SL, Sheets 1, 2, and 3, Second Revision;
- Rate A-ELI, Sheets 1 and 2, Original;
- Rate A-TD, Sheets 1 and 2, Original;
- Rate GS3-TD, Sheets 1 and 2, Original;
- Rate GSS, Sheets 1 and 2, Original;
- Rate GST, Sheets 1 and 2, Original;
- Rate GST-TD, Sheets 1 and 2, Original;
- Section 4, Sheet 4, Eighth Revision;
- Section 13, Sheet 13, Eighth Revision;
- Section 14, Sheet 14, Fourth Revision;
- Section 18, Sheet 18-E, Fourth Revision.

hearing conference for March 14, 1978 in order to consider the petitions to intervene and other procedural matters which might expedite the orderly conduct and disposition of the proceedings. A second pre-hearing conference was held on April 5, 1978 to discuss additional procedural matters.

Of the ten petitions to intervene, the Commission, by Order dated March 17, 1978, granted* intervenor status to the following nine parties: Martin-Marietta Corporation, Keyes Fibre Company, St. Regis Paper Company, Scott Paper Company, Maine Municipal Association (with the town of Farmington and the town of Litchfield),** the Consumer Coalition,*** the Maine Oil Dealers Association (hereinafter M.O.D.A.) and ten individuals complainants,**** Common Cause and several individuals,***** and the Natural Resources Council of Maine, the China Library Association, and several individuals.

On February 9, 1978, M.O.D.A. filed a complaint with the Commission alleging jurisdiction under 35 M.R.S.A. § 291

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* The petition to intervene by I.M.C. Chemicals, Inc. was denied. I.M.C. is located in Orrington, Maine, within the service territory of Bangor Hydro-Electric Company. The Commission held that I.M.C. did not have, nor was it likely, during the period this case was pending, to have a direct and substantial interest in this proceeding.

** Maine Municipal Association and the Towns of Farmington and Litchfield withdrew their complaints on April 5, 1978. The Commission granted the withdrawal on April 25, 1978.

*** The Consumer Coalition was referred to as the Reeves Group in the March 17, 1978 Order and consists of Bruce M. Reeves, a residential customer, and two organizations, the Maine Citizens Committee for Utility Rate Reform and the Consumer Action Coalition.

**** M.O.D.A.'s intervention was limited to participation as ratepayers.

***** The intervention of Common Cause, the Consumer Coalition and the Natural Resources Council was conditioned upon each group making a consolidated presentation.

and opposing the Company's rate increase requested in the present proceeding. The M.O.D.A. complaint was docketed as F.C. #2336, and the Company filed an answer and moved to dismiss. On March 7, 1978, M.O.D.A. moved to consolidate its complaint in F.C. #2336 with the present proceeding. The Commission, in its Order on Pre-Hearing Conference dated March 17, 1978, granted the motion to consolidate and denied the Company's Motion to Dismiss F.C. #2336. The Company then took a Rule 80B Appeal from this Order to the Superior Court. Also on March 17, 1978, the Commission granted a motion filed by the Consumer Coalition to require the Company to give notice to its ratepayers of hearing dates on which the general public could testify. The form of this notice was specified in the Commission's Order dated May 4, 1978.

After appropriate notice, hearings were held in this case on twenty-seven (27) days — May 8-12, 15-16, 19, 22-24, 30, 31, June 1-2, 12-16, July 10-12, 21, and August 7-9. The Company presented six witnesses: Elwin W. Thurlow, President, Chief Executive Officer, and a Director of the Company; Robert F. Scott, Senior Vice President in charge of Customer Services and Rates for the Company; Thomas C. Webb, Financial Vice President and Treasurer of the Company; Robert S. Howe, Comptroller of the Company; Frederick E. Anderson, Director of the Company's Rate Department; and Charles A. Benore, Vice President of Mitchell, Hutchins, Inc. and an investment analyst of utility securities. Mr. Benore testified on the Company's cost of capital and its construction work in progress. The Commission Staff (hereinafter Staff) presented the testimony and exhibits of David A. Kosh and Bruce M. Louiselle from the consulting firm of Kosh Louiselle Lurito & Associates, Incorporated. Mr. Kosh presented testimony on cost of capital and capital structure. Mr. Louiselle's testimony related principally to the Company's revenue requirements. A number of intervenors also presented direct testimony on cost of service, marginal

cost pricing, rate design, and some of the revenue requirement issues.

In all, parties to the proceeding sponsored twenty-one witnesses who testified at the hearings. The parties also introduced into evidence one hundred sixteen exhibits. Ninety-four public participants gave testimony or statements and presented twelve exhibits. The hearing was closed on August 9, 1978. Briefs were filed on August 23, 1978, and reply briefs were filed on September 1, 1978. Oral argument was held before the Commission on September 7, 1978.

Test Year

Both the Company and Staff have agreed, and no other party has disagreed, that the proper test year is the year ending December 31, 1977.

We find that the use of this test year with appropriate adjustments provides a reasonable and reliable source of figures on which to compute revenue requirement.

The Fair Rate of Return

Introduction

Evidence on the issue of fair rate of return was presented by both the Company and the Staff. Mr. Thomas C. Webb, Vice President of Central Maine Power, computed his recommended fair rate of return as follows:

Table I
Thomas C. Webb's Recommended Cost of Capital

	Capital Structure	*Cost*	*Weighted Return Requirement*
Debt	50.77%	7.98%	4.05%
Preferred	13.08%	7.03%	.92%
Equity	36.15%	14.25%	5.15%
		Total	10.12%

Mr. Charles A. Benore from Mitchell Hutchins, a New York based investment banking firm, testifying on behalf of the Company, also recommended a 14.25% cost of equity.

Mr. David A. Kosh, President of Kosh Louiselle Lurito & Associates, Incorporated, a public utility consulting firm, testifying on behalf of the Commission Staff, recommended a fair rate of return in the range of 9.28%-9.48% computed as follows:

Table II
David Kosh's Recommended Cost of Capital

A. *Based on the Pro Forma Capital Structure*

	Capital Structure	*Cost*	*Weighted Return Requirement*
Debt	50.5%	8.06%	4.07%
Preferred	12.9%	7.03%	.91%
Equity	36.6%	11.75%	4.30%
		Total	9.28%

B. *Based on the Desirable Capital Structure*

	Capital Structure	*Cost*	*Weighted Return Requirement*
Debt	52.0%	8.06%	4.19%
Preferred	13.0%	7.03%	.91%
Equity	35.0%	12.50%	4.38%
		Total	9.48%

As can be seen from Tables I and II, the differences in the recommended fair rates of return are due to three factors:

1. The cost of debt
2. The cost of equity
3. The capital structure

Cost of Debt

All three witnesses p. ojected the cost of debt beyond the end of the test year, i.e., beyond December 31, 1977. Both Mr. Webb and Mr. Kosh included long-term debt to be issued in 1978 in their calculations of the cost of debt. Messrs. Webb and Kosh also reflected an amount of short-term debt in their cost of debt calculations.

The only issue in determining the cost of debt on which the Company and the Staff do not agree is whether the cost of maintaining compensating bank balances should be included in the rate base or reflected in the cost rate of short-term debt. The Staff and the Company agree that such balances are maintained by Central Maine and that the reasonable costs of maintaining them should be borne by ratepayers.

The Staff contends that compensating bank balances should be reflected in the cost rate of debt because these balances increase the effective cost rate of short-term debt. The Company contends that treating these balances as a cost of capital, as the Staff suggests, would deprive the Company of compensation at times when it had no short-term debt outstanding.

The Commission believes that the Staff's approach is preferable to the Company's, because compensating balances are required as a condition to some of Central Maine's loan arrangements and therefore are a cost of borrowing. While it is always possible that Central Maine might have no short-term borrowings in the test year and no prospect of such borrowings during the time the rates would be in effect, that situation is highly unlikely, and it is not the case here. Even if it were the case, the Commission could still make an appropriate allowance for the cost of such balances in determining the Company's cost of debt.

The amount of the required compensating bank balances is also disputed, Mr. Kosh using $2.25 million and the Company

using $2.40 million. The evidence showed that the amount of cash actually on hand was considerably less than the stated bank balance requirements. We find that the compensating bank balance requirement of $2.25 million reflected in the cost rate of debt is reasonable.

A question was raised as to whether a fee arrangement in lieu of compensating bank balance requirements would be beneficial from the ratepayers' point of view. Since such fees are tax deductible, Central Maine should encourage its banks to accept such fee arrangements and keep us apprised of its efforts.

For purposes of this case we find that the appropriate cost of debt to use in determining the cost of capital and fair rate of return is 8.06%.

Cost of Preferred

As shown in the tables above, Mr. Webb and Mr. Kosh both testified to a 7.03% cost of preferred stock. We find that the appropriate cost of preferred stock to use in determining the cost of capital and fair rate of return is 7.03%.

Cost of Equity

The economic and legal standards used by commission and courts to test the reasonableness of the utility's earnings on equity are most clearly set forth in two landmark cases, *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia,* 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. 591 (1944).

In the *Hope* case, commenting on what constitutes a reasonable return to the equity owner, the Court, at p. 603, stated:

> "From the investor or company point of view it is important that there be enough revenue not only for operating

expenses but also for the capital cost of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."
(citation omitted)

These principles have been recognized by our Supreme Judicial Court in *Central Maine Power Company v. Public Utilities Commission,* 153 Me. 228, 136 A. 2d 726 (1957).

With these principles in mind, we shall consider the evidence presented. The Company's witness, Mr. Charles Benore, relied on three approaches in making his recommendation that Central Maine should be allowed a return on equity of 14.25%. In his first approach, he considered the relationship between the yield on long-term government bonds and the rate earned on the Company's book equity over the 1965-1968 period. During this period Central Maine's market-to-book ratio averaged 1.5. The Staff pointed out that were Mr. Benore's approach applied to the data for the entire period 1965-1976 the result would be a 12.2% return on equity. During that period the Company's market-to-book ratio averaged 1.18. It is clear that the market-to-book ratio *must be considered* since Mr. Benore has compared the market yield on bonds not to the market return on the Company's stock, but to the return on its *book* equity.

Mr. Benore offered the results of a survey he conducted as supporting his conclusions. Little weight can be attached to this survey. There was no showing that the sample was representative. There was also some doubt as to the meaning of the questions asked. The questions asked were imprecise and susceptible to varying interpretations by those answering.

The second approach used by Mr. Benore was to estimate

the total expected return for the Standard & Poor Index of 400 industrial stocks. This total return was estimated by adding the current dividend yield of the index to his estimate of future growth, producing a 14.6% required investor return. In short, Mr. Benore applied the discounted cash flow method to the S&P 400 index. In connection with this approach, Mr. Benore determined that while Central Maine has been more risky than the S&P 400 industrial index, it was his judgment that the Company will be somewhat less risky than the S&P 400 industrial index in the future and he thus recommended a somewhat lower return on equity.

Mr. Kosh pointed out that Mr. Benore's primary measure of risk, the standard deviation of the market rate of return, is not a valid measure of risk. According to Mr. Kosh, the standard deviation is a measure of absolute variations, and a more valid measure of risk would be one which measures relative dispersions. Mr. Kosh computed the coefficient of variation, a measure of relative dispersion, and found that on that basis Central Maine's risk was significantly less than the S&P 400 index. Furthermore, he pointed out that the S&P index is a weighted index and as such does not reflect the risks of the individual companies nor the average risk of the individual companies.

In commenting on Mr. Benore's DCF analysis for the S&P 400 index, Mr. Kosh pointed out an interesting dichotomy. Mr. Benore found a 14.6% investors' required return which if earned would according to DCF theory produce a market-to-book ratio of one. Yet in 1976 the S&P 400 industrials earned 14.1% and had a market-to-book ratio of 1.5. This suggests that the investors' required rate of return is less than the 14.6% found by Mr. Benore and less than the 14.1% actually earned on book value.

Mr. Benore's third approach was to apply Central Maine's estimates of the financial results of a 14.25% return on equity

to six standards which, in his opinion, are necessary for a fair return. We find that his standards of financial integrity are nothing more than unsupported opinion and are not probative of the Company's cost of equity.

Mr. Webb used a single approach in quantifying his recommended rate to be earned on book equity. Given a dividend-to-book ratio of 8.5% to 9.0%, Mr. Webb computed what return on book equity would be needed to produce a 1.25 market-to-book ratio. He concluded that a return in the range of 14.16% to 15.06% was needed and he recommended a return of 14.25%. Were Mr. Webb to have used a market-to-book ratio of one as his objective, his results would have been in the range of 11.33% to 12.00%.

The formula used by Mr. Webb is quite sensitive to changes in the assumed dividend payout ratio. For example, Mr. Webb used a 75% dividend payout ratio and found a 14.16% required return. Had he used a 78% payout ratio (Central Maine's actual over a recent period) he would have computed a required return of 13.62%.

The Staff witness, Mr. Kosh, relied on the investor expectations approach in determining the cost of equity. He used the discounted cash flow (DCF) method, a method which recognizes that the objective of an equity investor is the current and future income he can expect to obtain from his investment, income taking the form of current dividend income plus an expected growth in dividends. Given these expectations of income, the DCF method provides a discount or capitalization rate. This rate indicates the investors' earnings requirement.

Thus, the DCF method recognizes that the value of a dollar of income expected to be received in the future is less than the value of a dollar on hand today, less because it is an expectation and is subject to uncertainty and less because of the time value of money. The DCF method recognizes this phenomenon by relating the investor's purchase price to the in-

ve tor's expected future cash proceeds, i.e., dividends, and to the eventual sale price. The discount rate which equates the purchase price with the investor's total expected income including the eventual selling price is the equity capitalization rate, the cost of equity.

In applying the DCF method, Mr. Kosh selected Central Maine and a group of 10 comparable electric companies. He presented extensive analytical data showing the comparability of these companies to each other and to Central Maine Power Company. Mr. Kosh then developed the estimated growth rate in dividends per share and dividend yields for Central Maine and the comparable companies; first making several different analyses of the 11 companies, using the period 1965-1977 as the framework of his analysis, then developing the annual rate of growth in dividends and book value per share for the Company for the period beginning in 1965 and ending in 1977. On the basis of these analyses, as well as the other factors he analyzed and discussed, Mr. Kosh found that investors expect a 2.75% annual growth rate for the Company and 3.40% on average for the ten comparable electric operating companies. He then developed a dividend yield for these companies and used the average dividend yield for the 27-month period ending March 31, 1978.

On the basis of his analysis, Mr. Kosh found that the indicated equity capitalization rate, i.e., the investors' required return, was 11.50% for Central Maine, and 11.60% for the ten comparable electrics. Based on these data he found that the cost of equity for Central Maine Power Company is 11.50% to 11.75%.

Mr. Kosh testified that this was the cost of equity, a rate that, if earned, would produce a market price equal to book value per share. He stated that such a cost of equity is appropriate in this case because the Company's projected year-end 1978 equity ratio of 36.6% is above the upper end of the range of reasonableness. Therefore, he felt that the Company

would not need to issue additional equity capital in the intermediate term future in order to maintain a reasonable capital structure. In addition, the Company stated in its direct case that it did not plan to issue new equity capital until 1982. Mr. Kosh asserted further that it is only when the Company needs to attract additional equity capital that it should be allowed to earn at a rate in excess of the capitalization rate in order to cover the associated costs incident to the sale of additional equity.

Mr. Kosh testified that should the Commission find that the Company would have need to sell additional equity in the relevant future, a return on equity in excess of 11.5% to 11.75% would be appropriate. Mr. Kosh presented detailed analyses designed to demonstrate the extent to which the capitalization rate of equity should be increased to allow the Company the opportunity of selling additional equity at net proceeds no less than book value per share. He testified that a return on equity in the range of 12.3% to 12.6% would be sufficient to produce a 1.15 market-to-book ratio — a ratio which would meet the anti-dilution criteria. The 1.25 market-to-book ratio recommended by the Company's witnesses was not supported by any meaningful empirical analyses.

We believe that the DCF method, as presented by Mr. Kosh, conforms to the *Bluefield* and *Hope* requirements and is a useful tool in the determination of the cost of equity. We recognize that the application of the discounted cash flow method requires the exercise of informed judgment, since the DCF formula requires an estimate of future growth in dividends per share. For example, were the estimate of future growth for Central Maine Power Company to be 3.25% as opposed to the 2.75% used by Mr. Kosh, the minimum cost of equity would be 12% as opposed to the 11.50% computed by Mr. Kosh. Yet judgment plays no more of a role in the DCF analysis than in any other method of computing cost of equity. In the risk premium method used by Mr. Benore,

judgment is used to determine what markup above the cost of debt equity investors require; in the comparable investment return approach also used by Mr. Benore, judgment is necessary as to the riskiness of Central Maine equity relative to that of a group of industrials, and judgment is also necessary as to the estimate of expected return for such industrials. Another method, used by Mr. Webb, involved judgments as to prospective payout ratios and targeted market-to-book ratios.

In the final analysis the Commission must exercise its judgment based on its expertise and the evidence in the record. *New England Telephone and Telegraph Company v. Public Utilities Commission,* -A. 2d- (Me. 1978) (slip opinion at 74). As was stated by the California Public Utilities Commission in *Re Pacific Telephone & Telegraph Co.,* 77 P.U.R. 3d 1, 16 (1968):

> "In the final analysis, it devolves upon the judgment of the commission, after weighing the evidence presented by all of the experts who by their testimony, have sought to advise the commission, to determine and to set a fair and reasonable rate of return for the applicant. The testimony and exhibits presented by the rate of return witnesses are of aid to the commission in such determination even though the individual opinions of the witnesses, when standing alone, may be, inconclusive."

Based on the extensive record in this case it is our opinion that the appropriate cost of equity to use in the determination of the fair rate of return is 12.5% and that this rate will enable the Company to attract necessary equity capital on just and reasonable terms in order to achieve, if necessary, a reasonable capital structure at some point during the period the rates authorized therein are effective.

Capital Structure

As shown on Tables I and II, the pro forma capital struc-

ture relied on by the witnesses are not significantly dissimilar. In addition, the Company has presented its estimated capital additions over the next 10 years. While these data are based on various assumptions, some of which may be at variance with the facts, they indicate a plan to issue significantly more debt than equity. Indeed, over the period 1979-1981, Central Maine, according to these data, does not plan to issue additional equity capital. Consequently, if the Company follows through on these plans, its current 36.6% equity ratio will fall below 35% in the near term future.

Mr. Kosh testified at length concerning the Company's current equity ratio and what a reasonable capital structure would be. He concluded that 36.6% is above the zone of reasonableness. Given the facts that interest is tax deductible and that debt costs less than equity, it is clear that a capital structure containing less equity and more debt is more economical from the customers' point of view. It is also clear that what must be balanced against this advantage of economy is the potential disadvantage of insufficient safety. A desirable capital structure must strike an appropriate balance between safety and economy.

In concluding that 35% is a reasonable, desirable equity ratio Mr. Kosh analyzed the equity ratio of 64 original cost electrics and made studies of the safety of a capital structure containing 35% equity. He found that such a capital structure could withstand a fall in earnings that had a one in 100 chance of occurrence and still produce an after-tax interest coverage of over 2 times. In his opinion these studies confirmed that a capital structure containing 35% equity is safe and hence more economical than one containing more equity.

Ratemaking is by its very nature prospective. Consequently, we must be concerned with the capital structure over the period of time rates are likely to be in effect. Given the Company's projected construction program and financing plans, it appears that its equity ratio will average about 35% over

the next several years. Meeting this construction program may require the issuance of additional equity to maintain such an equity ratio. Furthermore, such a capital structure has been shown to contain the two necessary elements, safety and economy, and it is therefore reasonable.

Mr. Webb testified that the Company's current objective is to increase its ratio of preferred and common stock from 48% to about 50% to 52%. Central Maine has averaged approximately 45% preferred and common in the past and has exceeded 48% only once since 1970. In the Company's last case, F.C. #2168, the fair rate of return was based on a capital structure containing 31.9% equity, 13.0% preferred, and 55.1% debt. In the case before that (F.C. #2072), the fair rate of return was based on a capital structure containing 32.6% equity, 12.1% preferred, and 55.3% debt. As noted previously, this proceeding presents the Commission with capital structures containing significantly more equity and less debt.

In sum, Central Maine has been increasing its equity ratio and decreasing its debt ratio. The evidence suggests that this trend will be reversed at least for the next few years and that the equity ratio likely to obtain over the near term future of approximately 35% is reasonable. Furthermore, Central Maine's pro forma equity ratio of 36.6% is unreasonable and inefficient because it provides an excessive and unnecessary margin of safety which is being financed by ratepayers. For these reasons, we find that a capital structure containing 35% equity, 13% preferred, and 52% debt is appropriate and should be used to determine the fair rate of return.

Fair Rate of Return

Based on the above considerations and the extensive record in this proceeding, the Commission finds the fair rate of return to be 9.48%. The increase in rates authorized herein will be based on a fair rate of return of 9.48%.

Rate Base

The rate base consists of the investment made by various capital owners of Central Maine in utility plant that is used or required to be used in rendering utility service. The suppliers of capital are legally entitled to a reasonable opportunity to earn a fair return on their investment. Thus, the rate base multiplied by the fair rate of return equals the fair return or net operating income in dollars.

In this case the rate base issues were: 1) whether the reserve for injuries and damages should be deducted from rate base; 2) the extent to which plant held for future use should be included in rate base; 3) whether all construction work in progress (CWIP) should be included in rate base, and if so under what conditions; 4) whether the Company's working capital requirement should be adjusted to provide as a source of working capital funds in the Company's bank account between the date the Company pays for an expense and the date its bank account is debited; and 5) whether compensating bank balances should be included in rate base. We determined in the previous section that compensating balances are properly accounted for in determining the fair rate of return and should not be included in rate base.

Reserve For Injuries and Damages

The Company has accumulated a reserve for injuries and damages in the amount of $280,000 for the payment of claims which may arise through injuries or damages.

The Staff takes the position that Central Maine's reserve for injuries and damages, *i.e.*, uninsured losses, represents customer supplied capital and therefore should be deducted from rate base. This position is consistent with decisions of the Florida Public Service Commission in *Re: Tampa Electric Co.*, 9 P.U.R. 4th 402 (1975) and the Kansas State Corporation Commission in *Re: People's Natural Gas Division of Northern Natural Gas Company,* 90 P.U.R. 3d 496 (1971). Central Maine, in its reply brief, agrees with the Staff position. Accordingly, we conclude that the reserve for injuries and damages in the amount of $280,000 should be deducted from rate base.

Property Held For Future Use

The Company has included in rate base certain property allocated either to its Land Held For Use account (F.E.R.C., Form 1, Account 105) or to its account for Investment in Joint Corporate Projects. The property consists of a number of parcels of land which the Company has purchased over the years and which may be placed in useful service at some point in the future. The issues concerning this property involve how much of it is includable in rate base and when it should be included, if it should be included at all. The specific parcels with which we are here concerned are potential generating plant and transmission line sites at Sears Island, Stockton Springs, and Richmond.

Several proposals for the treatment of this property have been offered. The Staff has proposed that an adjustment be made to exclude from rate base those portions of two particular parcels which will eventually be owned by other electric companies. Central Maine could thus continue to earn the fair rate of return on the remaining portions. The two parcels affected are 400 acres on Sears Island and 1400 acres in Richmond. Both parcels are held by the Company as potential sites for electric generating plants which would be owned jointly by Central Maine and various other electric companies. The purpose of the Staff's proposed adjustment is to insure that Central Maine's ratepayers will not be forced to pay a return on property which will never be used by the Company for their direct benefit, i.e., that portion of the

property which will be owned by other electric companies when the land is placed in useful service. The Company agrees with this adjustment in principle. The Consumer Action Coalition, however, has proposed that all property included in the Land Held for Future Use and Investment in Joint Corporate Projects accounts be excluded from rate base until the properties are actually placed in service for the benefit of the ratepayers.

On several occasions in the past this Commission has felt constrained to exclude property held for future use from rate base. *See Re: Continental Telephone Co. of Maine,* 18 P.U.R. 4th 636, 643 (Me. P.U.C. 1977); *Re: New England Telephone and Telegraph Co.,* 5 P.U.R. 4th 387, 393 (Me. P.U.C. 1974). In *Fort Fairfield Light and Power Co. v. Maine Pub. Serv. Co.,* 1933B P.U.R. 493, 505 (Me. P.U.C. 1933), the Commission stated that:

> "While the company holds, however, assets not in public use, and for which no early public use is contemplated, it cannot have them included in the rate base merely because of a possibility that at some future time it may conclude to put them to service; in such cases, it may dispose of such properties without accounting to the public, or it may hold them without charging the public with a return on their value. If the time comes when properties thus speculatively held are properly put to public use, the company may then, and not before, add them to the general valuation upon which rates are to be predicated."

In that case, the Commission included property in rate base where it was satisfied that the property ultimately would be devoted to public use and excluded other property where it was not so convinced. This type of rationale was later approved and adopted in *Re: New England Telephone and Telegraph Co., supra* at 393-94, where the Commission excluded certain properties from rate base because the utility failed to supply evidence sufficient to demonstrate either the necessity of acquiring the properties far in advance of any possible construction date or the extent to which the Company had formalized its expansion plans and was financially committed to them. Numerous other commissions and at least one state court have also felt obliged to exclude property held for future use from rate base. *E.g. In Re Village of Stowe Electric Dep't.,* _____ Vt. _____, _____, 367 A. 2d 1056, 1060 (1976); *Re: Iowa Power and Light Co.,* 20 P.U.R. 4th 397, 406 (Iowa St. Com. Comm'n. 1977); *Re: Boston Edison Co.,* 16 P.U.R. 4th 1, 7 (Mass. D.P.U. 1976) (property excluded until used and useful).

Under the facts in the present proceeding we find that we cannot allow any of the value of property located at Richmond and Stockton Springs into rate base. Stockton Springs has been characterized merely as a "future/alternative site for steam generation" with the earliest possible date for utilization being the late 1980's. The possibilities for use of the Richmond site are even more remote. The earliest possible date for putting the land into service is 1991, although, according to the testimony of Mr. Thurlow, that date is "becoming less and less realistic all the time." Moreover, while the land is currently being considered as a sight for nuclear plant, the Company has expressed reluctance to move ahead on the project until some definite position in support of nuclear energy is taken by the federal government. Given the lack of any definite plan to use these two properties at any point in the foreseeable future, we cannot burden ratepayers for an indefinite period with paying a return on Company assets which confer no immediate benefit on and provide no guarantee of future benefit to Central Maine's ratepayers. Accordingly, the Richmond property, representing $1,109,249, and the Stockton Springs property, representing $492,350, must be deducted from rate base.

We find sufficient evidence in the record, however, to support a finding that a definite plan exists for the use of the

Company's property on Sears Island. An application is in fact now pending before this Commission concerning the Company's proposed use of the site for a coal-fired plant. Since only 81% of the Sears Island property will ultimately be owned and placed in service by Central Maine for the benefit of its ratepayers, however, we will deduct 19% of the land value of Sears Island,* amounting to roughly $143,136, from rate base.

We will not deduct from rate base in this proceeding any other properties now held by the Company for future use, because there is no evidence in the record to demonstrate either the existence or nonexistence of definite plans regarding the proposed use of these properties. In future rate cases, however, utilities must bear the burden of justifying the inclusion in rate base of property held for future use by demonstrating that a sufficiently definite plan exists for the use of such property. Imposition of this burden on utilities will insure that ratepayers will pay a return only on that property from which they are currently benefitting or from which they will benefit in the near future. The determination whether a sufficiently definite plan exists will, of necessity, be made by the Commission on a case-by-case basis, depending on the type of utility involved and the use which is being considered for the property.

Construction Work In Progress

Several issues arise in connection with the construction work in progress, (CWIP) in this case. CWIP is the cost of

* Included in the value of Sears Island is the average monthly investment of $210,000 associated with the land on which the plant will be located and an average monthly investment of $543,349 associated with land for transmission lines for the plant. The total average monthly investment for Sears Island, therefore, is $753,349.

utility operating property in the process of construction but not ready for service at the date of the test year balance sheet. CWIP will produce revenue only after it is placed in service.* The Allowance for Funds Used During Construction (AFUDC) reflects the capital costs associated with CWIP during the time prior to the plant being placed in service, that is, prior to the time it becomes revenue-producing.

Central Maine takes the following positions with regard to CWIP: 1) that its test year CWIP should be included in rate base; 2) that its test year CWIP should include all AFUDC accrued during the test year; 3) that in the future it should not be required to capitalize (and add to income) AFUDC on the 1977 test year amount of CWIP and 4) that to the extend CWIP exceeds the 1977 test year amount in the future, Central Maine should continue to capitalize (and add to income) AFUDC at a rate "net of taxes", that is, a rate which reduces the fair rate of return by the tax deduction associated with the Company's cost of debt.

The Staff takes the position that Central Maine's test year CWIP should be included in rate base; that the test year amount should be reduced by one-half of the AFUDC accrued during the test year; that Central Maine should be required to capitalize (and add to income) AFUDC on all CWIP in the future; and that the proper AFUDC capitalization rate is the fair rate of return.

The Consumer Coalition takes the position that CWIP should be excluded from rate base with the capitalized AFUDC not added to income, i.e., not reflected in the cost of service.

Many members of the public testifying in this case expressed a preference that the Company's rates reflect only

* CWIP as discussed in this opinion does not include Wyman Unit No. 4, which has been treated separately because of testimony that Wyman No. 4, while not yet operational, is expected to be placed in commercial operation shortly.

the cost of facilities that are providing service, as opposed to those which are still under construction.

The Commission, consistent with its findings in *Re: Central Maine Power Company,* 15 P.U.R. 4th 455, 469-472 (1976), *aff'd Central Maine Power Co. v. Public Utilities Commission,* 382 A. 2d 302 (Me. 1978) finds that the test year CWIP, excluding all CWIP associated with Wyman Unit No. 4 and one-half the AFUDC accrued during the test year, should be included in rate base, and that the Company should continue to accrue and include on its income statement AFUDC at an annual rate equal to the fair rate of return. These findings are consistent not only with our findings in previous cases, but also with our understanding of the testimony of the public about this issue. In other words, it is our view that the consumers who should pay for the cost of generating facilities are those customers who are served by those facilities.

The Commission considered and rejected a position similar to that of the Consumer Coalition in the last Central Maine rate case. See *Re: Central Maine Power Company,* 15 P.U.R. 4th 455 (1976). On the point, at p. 471, we said:

> "The difference between including CWIP in rate base and capitalizing AFUDC and eliminating CWIP from rate base, capitalizing AFUDC, but not including it on income statement for rate case purposes is negligible. Keys Fibre and Portland Pipe Line, therefore, contend that CWIP should be excluded from rate base and AFUDC excluded from revenue for rate-making purposes. The distinction is that if CWIP is not included in rate base and AFUDC is not shown in the income statement for rate case purposes, the Company will recover no capital costs on some small amounts of plant which are quickly constructed."

While the practical difference between the Consumer Coalition's position and the Staff's position is insubstantial, we believe the Staff position is preferable. For reasons expressed in the last case, we reject the Consumer Coalition's position that CWIP should be excluded from rate base.

Central Maine contends that test year CWIP of $22,815,000 should be included in rate base, but that AFUDC should be capitalized only on amounts of CWIP which exceed the test year amount. This argument would result in an increased current annual revenue requirement of about $4,469,000 for present ratepayers. We rejected Central Maine's position in its last rate case and we reject it again in this case. Central Maine contends that its position should be adopted because its construction expenditures have increased substantially; because it will improve its quality of earnings (According to Central Maine, AFUDC earnings recovered over the useful life of a plant through depreciation expense, are inferior to those recovered on a cash basis during construction) because it "reduces the long-term cost of power to ratepayers as compared to what such costs would be with continued capitalization of AFUDC on CWIP in rate base," because it "tends to reduce costs of capital by improving quality of earnings and will, therefore, reduce the frequency of rate cases;" and because it "is fair to ratepayers because their demands are creating the construction requirements." These are essentially the same arguments with which we dealt in the previous case.

Of course, permitting the Company to treat as an expense, rather than to capitalize, capital costs will improve its cash flow. However, as Mr. Louiselle testified, one need not be overly concerned with non-cash income when the income statement contains considerable amounts of non-cash expenses such as $6,200,000 of income taxes not paid because of the Job Development credit; the additional $6,400,000 of Job Development credit contained in the Staff's Wyman No. 4 adjustment, and $14,700,000 of depreciation expense, which is a non-cash expense. Very simply a number of non-cash items appear on Central Maine's income statement

which affect its level of book earnings, some of which require cash to finance (AFUDC) and some of which provide cash for financing needs (Job Development credits and depreciation expense). As Mr. Louiselle pointed out, there is no need to single out AFUDC for special treatment.

Under the Staff method, which we accept, the cost of construction capital is returned to the investor through the depreciation expense. The certainty of the return of construction capital is far greater under the Staff method than under the Company method where the investor earns his return on his construction investment only if the Company earns at least the fair rate of return. And considering only the construction capital, in those years when the Company earns less than a fair return, the investor loses forever his opportunity of earning a fair return unless the capital costs are capitalized.

The Staff witness, Mr. Louiselle, demonstrated that the investor is fully compensated for the use of his funds under both the Staff and Company proposals and thus, the investor should be satisfied with either of the two proposals. Ratepayers, on the other hand, feel strongly opposed to paying a return today on a plant which is to be operational at some future date. This was manifest from the testimony of public witnesses. Moreover, Mr. Louiselle in his exhibit, P.U.C. Exhibit 12, Appendix p. 2, demonstrated that consumers are better off when the construction-related capital costs are capitalized.

We have again carefully considered this matter and we believe the Staff proposal for capitalizing AFUDC on all CWIP is based on sound principles of regulation, represents good regulatory practice, is a fairer and less costly method for ratepayers and is not unfair to the Company's investors.

Central Maine takes issue with Staff witness Louiselle's removal, from CWIP, of one-half of the AFUDC accrued during the test year. Mr. Louiselle presented an exhibit, P.U.C.

Exhibit 12, Appendix p. 4, which demonstrates that the adjustment is necessary to prevent total earnings from exceeding the amount that must be received to pay the cost of capital. Mr. Louiselle's demonstration assumes a year-end rate base and thus shows the necessity of excluding all test year AFUDC from CWIP to prevent over-recovery of return on net plant in service. The principle is the same where, as here, an average year rate base is used. The only difference is that one-half of the AFUDC accrued during the test year must be excluded from CWIP to prevent over-recovery of return on net plant in service. As Mr. Louiselle testified, one reason this adjustment is necessary is because the fair rate of return is an annual rate, that is, the fair rate of return assumes that the capital costs are paid annually. In 1977, however, Central Maine started compounding AFUDC on a semi-annual basis. The adjustment Mr. Louiselle proposes merely places the AFUDC rate on the same annual time basis as the fair rate of return .We find the adjustment is just and reasonable. Accordingly, we eliminate $927,000 from the Company's test year CWIP as recommended by Mr. Louiselle.

In connection with this adjustment, we note that Mr. Amero, Counsel for Central Maine, by letter dated September 25, 1978, brought to the attention of our Mr. Samp that there was a disparity between the Staff witness's Exhibit and work papers as to the proper amount of CWIP to be included in rate base. We have corrected this inconsistency in our rate base calculation.

Central Maine recommends that the AFUDC rate, if employed, be set at a rate "net of taxes" that is, the rate of return reduced by the tax deduction on the interest component of the composite cost of capital. Central Maine brings to the Commission's attention the fact that the Law Court in *Central Maine Power Company v. Public Utilities Commission,* 382 A. 2d 302, 321 (Me. 1978) has recently held that this

issue is a matter within the Commission's discretion. Central Maine, citing four regulatory agency decisions, requests the Commission to exercise its discretion in favor of the "net AFUDC rate."

The Staff takes the position that the AFUDC rate should equal the gross capitalization rate; that is, the fair rate of return. The Staff witness clearly demonstrated that use of a rate for AFUDC less than the fair rate of return has the effect of shifting the burden for this portion of the CWIP from the future customers to current customers. The effect of Central Maine's position is thus to increase the revenue deficiency by lowering the AFUDC rate and, therefore, the amount of AFUDC credited to operating income. Consistent with our decision on this issue in Central Maine's last rate case, *Re Central Maine Power Company,* 15 P.U.R. 4th 471-472 (Me. P.U.C. 1976), and our policy that utilities should only charge to ratepayers those income taxes which are actually paid, *e.g., The Mechanic Falls Water Company, et al.,* 13 P.U.R. 4th 347 (Me. P.U.C. 1976), we accept the Staff position.

The regulatory agency decisions are divided on this question. Those which support our resolution of the issues include: *Re: Florida Power and Light Co.,* 9 P.U.R. 4th 146 (Fla. P.S.C. 1975); *Re Midstate Telephone Company, Inc.,* 10 P.U.R. 4th 88 (N.Y. P.S.C. 1975); *Re Pennsylvania Electric Company,* 10 P.U.R. 4th 351 (F.P.C. 1975); *Re Iowa Power and Light Company,* 6 P.U.R. 4th 466 (Iowa S.C.C. 1974); *Re: Hawkeye State Telephone Company,* 2 P.U.R. 4th 166 (Iowa S.C.C. 1973).

The one argument concerning this issue which we believe requires further comment is Central Maine's contention that use of the gross capitalization rate as the AFUDC rate creates an illogical mismatch of revenues and expenses. In other words, by requiring that AFUDC be capitalized, the Commission is deferring those costs to future ratepayers. Thus, says Central Maine, the Commission should also defer

the tax deductions associated with those costs. The Staff witness, Mr. Louiselle, responded to this assertion, pointing out that customers in the future receive tax deductions that exist at that time, and that present taxable income is created by revenue paid by current customers. Without that revenue there is no taxable income, and current customers who create the taxable income should receive the tax deduction. We are satisfied, for present purposes, that future customers will not pay higher rates because the current tax deduction is flowed through to current customers. Therefore, we find that the fair rate of return, *i.e.,* the gross AFUDC rate, is just and reasonable for purposes of computing AFUDC.

Working Capital: Disbursement Lag

In developing Central Maine's working capital needs, Mr. Howe did a lag study of the average time between the rendering of service and the receipt of revenues for that service and between the rendering of service and the payment payment of expenses incurred in providing that service. In computing his revenue lag, Mr. Howe included the time between the date the revenue is received by the Company from the customer and the date the money is credited to Central Maine's bank account. Thus, Central Maine took the position that it had a need for working capital during this period. Mr. Howe, however, did not reflect as a lag in expenses the period between the date the Company pays for an expense and the date its bank account is debited. This period provides Central Maine with a source of working capital. Mr. Louiselle, the Staff witness, assumed a three-day lag between the time the Company pays an expense and the time its bank account is debited. We believe Mr. Louiselle's assumption is just and reasonable and necessary to account for the expense lag on the same basis that the Company used in computing its revenue lag. Accordingly, we accept Mr. Louiselle's

"disbursement lag" adjustment to Central Maine's working capital requirement.

Based on the foregoing discussion, we find a rate base of $389,130,000 to be just and reasonable. Table III shows the computation. Using our finding of a 9.48% fair rate of return, we calculate that Central Maine's test year return requirement is $36,890,000.

TABLE III
CENTRAL MAINE POWER COMPANY
RATE BASE
AVERAGE FOR YEAR ENDING DECEMBER 31, 1977
($1,000)

1.	Plant In Service		$466,643
2.	Accumulated Depreciation		(144,290)
3.	Net Plant In Service		$322,353
4.	Plant Held For Future Use		2,382
5.	Investment In Joint Corporate Projects		34,792
6.	Construction Work In Progress		21,888
7.	Working Capital Requirements		26,859
	Non-Investor Supplied Capital		
8.	Customer Deposits	$ (250)	
9.	Accumulated Deferred Taxes	(18,210)	
10.	Reserve for Injuries and Damages	(280)	
11.	Customer Advances	(404)	
12.	Total Non-Investor Supplied Capital		($19,144)
13.	RATE BASE		$389,130

Test Year Adjusted Net Operating Income

The Commission has determined the test year net operating income for Central Maine which it finds just and reasonable. To determine the revenue adjustment that is required in this proceeding, the just and reasonable net operating income

must be compared with the test year net operating income which the Company earned as that amount is adjusted. When an appropriate amount of Allowance for Funds Used During Construction (AFUDC) is included as income on Central Maine's test year income statement, its net operating income was $34,009,000.*

Central Maine, the Staff, and the Consumer Coalition suggested adjustments to the test year net operating income. Some of these proposed adjustments were uncontested. The uncontested adjustments were attributed to: 1) an increase in the Company's 1977 property taxes which decreases net operating income by $55,000; 2) income earned on Central Maine's equity investment in subsidiary or affiliated Companies which increases net operating income by $2,000; 3) the application of Central Maine's rates to former customers of Rangeley Power Company which decreases net operating income by $44,000; and 4) the elimination of Central Maine's present rates H, I, J, M, and SC and the movement of customers presently on those rates to the general service rates for which Central Maine believes they qualify, which increases net operating income by $240,000. Other uncontested adjustments arose from Central Maine's increased wholesale rates pursuant to a Federal Energy Regulatory Commission order dated March 16, 1978, which increases net operating income by approximately $38,000, and a loss of revenue occasioned by Scott Paper Company's generating its own electricity at its Somerset plant, which reduces net operating income by $242,000.* Uncontested adjustments result from: placing

* The difference between the $34,009,000 and Central Maine's $32,155,456 is attributed to AFUDC in the amount of $1,854,000.

* The Staff opposed this adjustment until cross-examination in the surrebuttal phase of the hearings when the Staff witness agreed that some adjustment should be made. In its brief the Staff included this adjustment in its net operating income computation.

purchased power expenses (the NEPEX Savings Fund) on an actual 1977 billing basis which increases net operating income by $4,000; increased liability insurance premium for 1978 which decreases net operating income by $140,000; an increase in postage rates which decreases net operating income by $22,000; a decrease in the State income tax rate which increases net operating income by $6,000; and the elimination of the test year income taxes on capital gains which increases net operating income by $70,000. The 1977 and the 1978 wage contracts account for adjustments which decrease net operating income by $179,000 and $535,000 respectively. Flow-through of the tax effects of capitalized pension and payroll taxes, which results in a $102,000 increase in net operating income, and flow-through of the tax effect of capitalized payroll taxes in Central Maine's test year payroll adjustment which results in a decrease of $63,000 in net operating income. As part of its direct case, Central Maine filed a payroll adjustment. It does not contest the previous four adjustments which were offered by the Staff in lieu thereof. We have reviewed these uncontested adjustments and find them to be just and reasonable. The total effect of these adjustments is to reduce test year net operating income by $818,000.

In addition to the foregoing uncontested adjustments, there are eight proposed adjustments which are contested. The contested adjustments concern: 1) expenses incurred in connection with judicial review of Central Maine's last rate case, Public Utilities Commission Docket F.C. #2168; 2) certain 1978 advertising expenses; 3) flow-through of the tax benefits resulting from the Company's use of accelerated depreciation under Maine State Income Tax Law; 4) plant financed by deferred taxes; 5) benefits from accelerated depreciation on replacement property; 6) abnormal storm damage costs; 7) the discount for electric service available to Central Maine's employees; and 8) AFUDC. We discuss each of these contested adjustments separately.

Expenses Incurred In Connection With Judicial Review of F.C. #2168

After the Commission's rate increase decision in F.C. #2168, *Re: Central Maine Power Company,* 15 P.U.R. 4th 455 (Me. P.U.C. 1976), the Company took an appeal to the Law Court which resulted in the decision in *Central Maine Power Company v. Public Utilities Commission,* 382 A. 2d 302 (Me. 1978). As a result of the appeal, the Company incurred expenses of $51,676 which are being amortized over a 3-year period, leaving approximately $17,000 in the 1977 test year. The Staff has proposed that an adjustment be made to disallow certain of the appeal costs. The Company opposes the adjustment. After considering the arguments on both sides, we conclude that this is not an appropriate case in which to make the adjustments advocated by the Staff. Accordingly, no adjustment is ordered.

Advertising Expenses

During the course of the present proceedings, the Consumer Coalition filed a motion requesting that the Commission order the Company to account for certain advertising expenses undertaken in 1978 so that they would not be charged to the ratepayers. The Consumer Coalition alleged that these were political advertisements constituting an effort to influence the decision of the Commission in this proceeding. Common Cause joined in the motion, which the Company opposed. The Company and the Coalition submitted memoranda of law to the Commission in support of their positions, and oral arguments on the motion were heard by the Commission on August 8, 1978.

The Consumer Coalition also submitted a data request with its motion and asked the Commission to order the Company to respond. The Commission modified the data request some-

what and, by order dated August 31, 1978, ordered the Company to answer it. The request asked the Company to list the advertisements it had sponsored since July 1, 1978, when and where they appeared, and what they cost. Safety advertisements were excluded. The Company was also asked to indicate to what account the cost of each advertisement would be allocated and how the different accounts were described. The Commission reserved decision on the motion until after the data request was answered.

On September 14, 1978, Central Maine answered the data request. It provided copies of five different advertisements which it had used between July 1, 1978 through September 14, 1978. Of these five, two had been the subject of much debate during the oral argument on the Consumer Coalition's motion, and the other three had not previously been discussed. The Company indicated where and when each advertisement had appeared, how much each appearance cost, and to what account numbers the costs were charged. The Company indicated, by letter from its counsel, Gerald Amero, dated September 14, 1978, that it considered the data request as something outside of the rate case itself, because the record was closed and because 1978 expenses are irrelevant to the 1977 test year. The Company's counsel further stated that all five of the advertisements would be charged "above the line" in any future rate proceeding with a 1978 test year.

We agree that the expenses for this advertising are not directly related to the 1977 test year, since they were incurred in 1978, and that they are, therefore, irrelevant to our determination of the Company's revenue requirements.

We have, however, examined each of the advertisements, pursuant to our authority under 35 M.R.S.A. §§ 4, 5, and 55. Three advertisements, "At Your Service", "Compare Your Electric Bill", and "Computer Print Out" were charged to Account Nos. CMP-719094, MPUC-719, and FERC-930.1. This account is called "General (institutional or image)", according to the Company, which bases its definitions on those in the Federal Energy Regulatory Commission's Uniform System of Accounts. Central Maine defines the general advertising account this way:

> "General (institutional or image) — Activities which are primarily designed to inform the public of Company involvement in programs which protect health and safety, protect the environment, conserve energy or improve the quality of service. The cost of advertising activities on a local or national basis which are primarily designed to improve the image of the Company or the electric utility industry are also includable in this category."

The "At Your Service" advertisement informs customers of certain information which they can obtain from the Company. The "Compare Your Electric Bill" and "Computer Print Out" items are based on a survey which was also offered by the Company as evidence in this case, showing a comparison of typical residential electric bills from the "top 100" electric companies in the United States. Central Maine ranked 86th, and the advertisements touted the Company's low rates.

The "At Your Service" advertisement seems appropriately assigned to the general advertising category, since it relates to programs which could be said to "improve the quality of service" of the Company. The other two advertisements are more questionable; they could be said to be "designed to improve the image of the Company" (general advertising); or they might be considered "messages designed to promote or retain the use of utility service", the Company's definition of promotional advertising.

While we fail to grasp the logic of advertising low residential rates in the midst of a case in which a 17% increase in those rates is being requested, we do not believe that these advertisements are so clearly in the wrong account as to warrant such a finding here.

Finally, the advertisements entitled "Got A Question About Your Electric Service" and "When They Grow Up" were accounted for as "Informational and instructional" advertising, Account Nos. CMP-719090, MPUC-719, and FERC-909, which Central Maine defines as follows:

> "Informational and instructional — Activities which primarily convey information as to what the Company urges or suggests customers should do in utilizing electric service wisely. Advertising messages may enumerate practices to protect health and safety, to encourage environmental protection, to utilize equipment safely and economically or to conserve energy."

The inclusion of the "Got A Question About Your Electric Service" item in this category seems appropriate, since it tells customers whom to call for assistance with billing or service problems. The "When They Grow Up" advertisement, however, is clearly misplaced in this category and seems to us to fit precisely in the "Political" account, which the Company defines this way:

> "Political — Activities which convey messages which are intended to influence public opinion with respect to the election or appointment of public officials or adoption or modification of referenda, legislation or ordinances, or for the purpose of influencing the decisions of public officials. Charges to this category are 'below the line' and not charged to the ratepayers."

The text of the advertisement is as follows:

> "When they grow up, there won't be enough electricity to go around. Unless we build new power plants now.
>
> "If things keep going the way they are now, they won't be able to find jobs here by the time they're 21, because we won't have enough power to go around.
>
> "That's a pretty pessimistic outlook, but its not all that far-fetched. We need to keep pace with the ever increasing demand for electricity.

> "Maine's population is growing every year, and it's obvious that the more people we have, the more electricity they'll use.
>
> "But right now, regulatory procedures and the regulations themselves are extending the time it takes to build plants. This adds millions of dollars in inflationary costs that all of us will have to pay for, sooner or later, and it makes our prediction that we'll begin to run out of power in the late 80's more accurate every day.
>
> *"We're caught between a rock and a hard place, because we can't seem to convince The People Who Run The World that there's a time problem.*
>
> "We need public opinion on our side so we can provide the electrical energy we're required to by law. We've got to build those new plants or our kids will live in a vastly different world than the one they know now."
>
> [Emphasis in original]

It should be noted that political advertisements are the only ones not charged to ratepayers by the Company. The "When They Grow Up" advertisement appeared in twenty-three newspapers throughout Central Maine's service territory between August 1 and 24, 1978, while the rate case was being considered by the Commission. The advertisement is critical of regulatory procedures and those who administer them ("The People Who Run The World"), and it clearly seeks to influence public opinion. It could easily be said to have been intended "for the purpose of influencing the decisions of public officials", including this Commission, which had before it not only the present rate case, but also an application from the Company for a coal-fired generating plant at Sears Island.

How the Company can consider this message to be "informational and instructional", within the limits of its own definition, escapes us. It says nothing about using electric service wisely, or about health, safety, environmental protec-

tion, energy conservation, or the safe and economical use of equipment.

Although the amount spent on this advertisement was just over six thousand dollars, we think that it is wrong, by the Company's own definition of its advertising accounts, to charge these costs to ratepayers as "informational" advertising. Many ratepayers who testified at the public hearings in this case are very much opposed to the position put forward by the Company in this advertisement. The judgment to run it during a major rate case is certainly questionable. But the main point is that ratepayers of a monopoly, having no choice of where to obtain service, should not be forced to pay for advertising that does not directly benefit them and particularly should not have to pay for political advertising.

Therefore, we find that the "When They Grow Up" advertisement should be accounted for as political advertising, and since the Company accounts for its political advertising expenses below the line, we order Central Maine to account for this advertisement below the line in 1978.

Flow-Through of Tax Benefits Resulting From the Company's Use of Accelerated Depreciation Under Maine State Income Tax Law

During the test year the Company used accelerated depreciation in computing its state income tax liability and for state income tax purposes in its regulated books of accounts. Had the Company taken straight-line depreciation for these purposes, its state tax liability would have been increased by $217,030. The Company now proposes that an adjustment in that amount be made in computing its expenses for rate-making purposes, thereby requiring that rates be set as though the Company had in fact taken only straight-line depreciation. Such an adjustment, the Company argues, should be allowed since it affords the Company "temporary" use of funds provided by the "postponement" of tax

payments and provides a desirable source of internally generated, low cost capital funds.

The Staff opposes this argument, proposing to flow-through the state tax benefits of accelerated depreciation. This proposal would insure that ratepayers be charged only the actual amount of tax liability incurred by the Company.

In *Re: Central Maine Power Co.*, 15 P.U.R. 4th 455, 472-74 (Me. P.U.C. 1976) this Commission rejected Central Maine's request for the type of adjustment requested here. The Commission found that flow-through of the effects of accelerated depreciation on state income taxes would not jeopardize the Company's ability to continue to take accelerated depreciation for state or federal purposes and that, given the continued growth expected in the Company's depreciable plant, accelerated depreciation resulted in a permanent tax saving. We, therefore, decided that, consistent with our past practice. *See Re: Central Maine Power Co.*, 17 P.U.R. 3d 452, 462 (Me. P.U.C. 1957), only the state tax liability actually incurred was chargeable to the ratepayers. Our decision was upheld in *Central Maine Power Co. v. Pub. Util. Com'n.*, 382 A. 2d 302, 318-21 (Me. 1978).

It is now clear that there is no legal proscription to flow-through of state tax benefits resulting from the use of accelerated depreciation and that the determination whether to require flow-through is a matter within our discretion.

We find that there are permanent tax savings resulting to Central Maine from the use of accelerated depreciation. Mr. Louiselle explained that:

> "The use of the words 'Deferred Taxes' suggests that these amounts will, at some later date be paid to the taxing authority. In fact, as long as the total excess of tax deductions over book deductions does not decrease, the actual taxes paid will never be more than under this normalization method.
>
> "The only requirement for deferred taxes not to be

paid is that depreciable plant does not decrease while the company has taxable income. In fact, as long as the plant continues to grow, the taxes actually paid will always be less than those included as operating expense under the normalization method."

Mr. Louiselle also gave assurance that Central Maine's depreciable plant will continue to grow for the indefinite future:

"For the period 1951-1977 gross electric plant has grown at a compound annual rate of approximately 5%. Furthermore, even if we assume that in the future no new customers will be added the mere fact that prices of plant have increased over the past and will most likely increase in the future, means that plant, when replaced, will be at higher prices. That being so, depreciable plant under the condition of no new customers, will continue to grow and thus the tax savings will continue."

Mr. Louiselle's conclusion, moreover, finds support in both our own prior decisions, and in those of other courts throughout the country. *E.g. Fed. Power Comm'n. v. Memphis Light, Gas and Water Div.,* 411 U.S. 458, 460 (1972); *City of Los Angeles v. Pub. Util. Comm'n.,* 125 Cal. Rptr. 779, 782, 785, 542 P. 2d 1371 (1975), *Re: New England Tel. & Tel. Co.,* Docket Nos F.C. #2213, U. #3178, C. #429 (Me. P.U.C. June 10, 1977); *Re: Central Maine Power Co.,* 15 P.U.R. 4th 455, 473 (Me. P.U.C. 1976).

We also find that it makes no economic sense to allow the Company to use funds accumulated in its deferred tax reserve as a source of capital. As we made clear in *Re: New England Tel. and Tel. Co., supra* at 48:

"The evidence clearly shows that in order to get $1 cost of capital through deferred taxes, the customer must put up approximately $2 of capital in order to provide the revenue to pay the tax to the I.R.S. on income. Even if the Commission were to decide that New England needed massive infusions of forced capital from the

ratepayer, the deferred tax method would not make economic sense."

Accordingly, we disallow the Company's proposed adjustment and accept the Staff's proposal to flow through to ratepayers the benefits of accelerated depreciation available to the Company for state income tax purposes.

Plant Financed By Deferred Taxes

The Staff proposes to reduce test year depreciation expense by $648,000 in order to eliminate depreciation on plant financed by deferred taxes. The Staff contends, and the Company agrees, that deferred taxes represent non-investor supplied capital. As such, the capital is merged with all other capital, and the plant financed by it is depreciated at the overall composite depreciation rate for Central Maine Power Company.

The Staff argues that this Commission should follow its stated policy of disallowing depreciation on non-investor financed plant. *Mechanic Falls Water Company,* 13 P.U.R. 4th 347 (Me. P.U.C. 1976); *affirmed, Mechanic Falls Water Company v. Public Utilities Commission,* 381 A. 2d 1080 (Me. 1977); *Central Maine Power Company,* 8 P.U.R. 4th 277 (Me. P.U.C. 1975).

All parties agree that Central Maine should not earn a return *on* plant financed by deferred taxes, and Central Maine therefore deducts accumulated deferred tax reserves from rate base in its regulated books of account. Staff extends this principle and argues that Central Maine should not earn a return *of* plant financed by deferred taxes, i.e., by non-investors. Mr. Louiselle, testifying on behalf of the Staff, made clear that there is no logical reason why ratepayers, as suppliers of capital, should not receive both a return *on* and *of* their capital. By disallowing depreciation on plant financed by ratepayers, we assure that shareholders do not receive,

through depreciation, the return *of* capital which they have not supplied. As a matter of policy, we agree that depreciation on plant financed by deferred taxes is not a proper expense for rate-making purposes.

The Company's primary objection to the proposed Staff adjustment is that, because of certain provisions of the Internal Revenue Code, such an adjustment might endanger Central Maine's ability to enjoy the benefits of accelerated depreciation for federal income tax purposes. We have examined the relevant provisions of the Internal Revenue Code and the associated Treasury Regulations, and we conclude that the proposed adjustment poses no possibility of adverse tax effects. Under § 167(*l*) of the I.R.C., Central Maine must use a normalization method of accounting with respect to any post-1969 public utility property to the extent that the property increases the Company's productive or operational capacity. I.R.C. § 167(*l*)(2), § 167(*l*)(4)(A). In order to use a normalization method of accounting,

> "the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account." I.R.C. §167(*l*)(3)(G)(i).

Central Maine suggests that the Staff's adjustment might result in a different "method of depreciation" for tax purposes and for rate-making purposes within the meaning of § 167(*l*), and that therefore, the Company might be precluded from using accelerated depreciation for federal income tax purposes. Presumably, the "method of depreciation" would be different because the amount of property being depreciated for tax purposes (which includes property financed by deferred taxes) would exceed the amount of property being depreciated for rate-making purposes and in the Company's regulated books of account (which would not include property financed by deferred taxes).

Initially, we note that if Central Maine's interpretation of § 167(*l*) is correct, the Company already fails to meet the requirements of a normalization method of accounting and is not now eligible to claim accelerated depreciation for federal income tax purposes. On its regulated books of account, Central Maine claims "tax" straight line depreciation for tax purposes which is different from "book" straight line depreciation for purposes of depreciation expense. Under the Company's reading of the statute, however, this accounting difference should result in disqualification from using accelerated depreciation for federal income tax purposes. Yet to our knowledge, the Internal Revenue Service has never sought to disallow Central Maine's use of accelerated depreciation, nor has the Company filed an income tax return voluntarily eschewing the benefits of accelerated depreciation.

Treasury Regulation § 1.167(*l*)-1(a)(2) makes it clear that the Staff's adjustment would not result in different "methods of depreciation" and would not endanger Central Maine's right to use accelerated depreciation. That section provides in part:

> ". . . For purposes of section 167(*l*), a change in a uniform rate of depreciation due to a change in the useful life of the property or a change in the taxpayer's unrecovered cost *or other basis* for the property *is not a change in the method of depreciation*. . . . Further, the use of an unrecovered cost *or other basis* or salvage value for Federal income tax purposes different from the basis or salvage value used on the taxpayer's regulated books of account *is not treated as a different method of depreciation*."
>
> (Emphasis added).

Therefore, it is clear that the Staff's adjustment would not endanger the Company's right to use accelerated depreciation, and we can find no reason to depart from our estab-

lished policy of disallowing depreciation of non-investor supplied property. We therefore increase net operating income by $314,000.

Benefits From Accelerated Depreciation On Replacement Property

This Commission has stated on numerous occasions that it will flow-through to ratepayers the tax benefits of accelerated depreciation to the extent that a utility's right to use accelerated depreciation for tax purposes is not jeopardized. *New England Telephone and Telegraph Company,* F.C. #2213, U. #3178 (Me. P.U.C. 1977); *Mars Hill and Blaine Water Company,* 19 P.U.R. 4th 380 (Me. P.U.C. 1977). Furthermore, the Supreme Judicial Court has affirmed on several occasions that this policy is within our discretion. *New England Telephone and Telegraph Company v. Public Utilities Commission,* _____ A. 2d _____ (Me. June 28, 1978); *Central Maine Power Company v. Public Utilities Commission,* 382 A. 2d 302, 319 (Me. 1978); *Mechanic Falls Water Company v. Public Utilities Commission,* 381 A. 2d 1080, 1100-02 (Me. 1977); *Central Maine Power Company v. Public Utilities Commission,* 153 Me. 228, 248-49, 136 A. 2d 726, 738-39 (1957).

Under § 167(*l*)(2)(C) of the Internal Revenue Code, Central Maine may claim accelerated depreciation while using flow-through accounting. However, § 167(*l*)(4)(A) permits certain public utilities to elect to be ineligible for accelerated depreciation unless they use a normalization method of accounting "with respect to any post-1969 public utility property which increases the productive or operational capacity of the taxpayer." Central Maine elected to restrict its options under § 167(*l*) and to eliminate the possibility of flow-through accounting with respect to post-1969 expansion property.

Despite that election, however, Central Maine did not elect, nor did it have the power to elect, normalization accounting with respect to post-1969 non-expansion property. Therefore, this Commission is free to require flow-through accounting with respect to that property without jeopardizing Central Maine's right to use accelerated depreciation for federal income tax purposes. In accord with the policy considerations which we have stated on several occasions, we will require flow-through of the benefits of accelerated depreciation with respect to post-1969 non-expansion property. This adjustment increases net operating income by $376,000.

Storm Damage Adjustment

Severe snow and wind storms along the coastal section of Maine caused Central Maine to incur high storm damage costs during the test year. The Company, recognizing that the costs were abnormal, adjusts for its test year storm damage expenses thereby increasing its net operating income $221,489. Were the abnormally high storm damage expenses not removed from the test year, Central Maine's new rates would be calculated as if such abnormal expenses were to be incurred in future years while the new rates are in effect.

The Staff agrees that the storm damage costs were abnormal and should be adjusted to reflect normal storm damage expense. It does not agree with Central Maine as to the method or amount of the adjustment. The Staff proposes an adjustment which would increase net operating income by $231,000.

Central Maine developed its adjustment by applying a labor index to historic storm damage expense. The problem with this method is, as the Staff points out, the labor index was applied to the entire historic storm damage expense, not just the labor portion thereof. Non-labor expenses have not necessarily changed at the same rate as labor expenses.

The Staff computed the average storm damage expense for

the five year period 1972-1976. It compared that average to the actual 1977 amount and amortized the differential between the two amounts over a five year period. The Staff's five year amortization period is based on the assumption that abnormal storms occur once every five years, an assumption which we find reasonable.

We find the Staff's proposed adjustment to be just and reasonable. Moreover, we observe, as Mr. Louiselle pointed out, that unless storm damage expense in the future is less than normal, Central Maine will not, under its adjustment, recover the full cost associated with the abnormal storm of 1977 because it includes no allowance for the possibility of an abnormal storm. Having accepted the Staff proposed adjustment, we increase the Company's net operating income by $231,000.

Employee Discount

Central Maine Power Company offers to its full-time and retired employees a discount on residential electric service. The discount is computed as a flat 33⅓ percent decrease on the total electric bill excluding the fuel charge. No tariff describing the discount is on file with the Commission. Although this practice does not result in unlawful rebates since it is specifically excepted under 35 M.R.S.A. § 103, we must still determine whether the cost of the discount may be passed on to ratepayers in just and reasonable rates. 35 M.R.S.A. §§ 51, 294.

The Company's President, Mr. Thurlow, testified that the employee discount originally was instituted in part as a promotional rate to encourage increased employee use of electricity. While the cost of discounts in some instances may be chargeable to ratepayers as a reasonable form of employee compensation, we find that Central Maine's discount is not a reasonable form of employee compensation. The level of

benefits received by any given employee depends solely upon his or her level of electricity use, not upon his or her position with the Company, seniority, salary, or any other objective standard for employee compensation. The same is true for the discount as applied to retired employees.

In this era of energy shortages and rising marginal costs of producing electricity, we find it unreasonable for the Company to provide a discount in order to promote electricity use. While we are not ordering a stop to the discount at this time, we will not permit the cost of the discount to be passed on to ratepayers.

This adjustment increases net operating income by $121,000.

Allowance for Funds Used During Construction (AFUDC)

We discussed in the rate base section of this opinion the policy considerations regarding CWIP and AFUDC. One of those considerations was that AFUDC should be capitalized at a rate which equals the fair rate of return. During the test year Central Maine capitalized AFUDC at an average rate of 9.03%. The test year fair rate of return as found herein is 9.48%. We adjust test year AFUDC by increasing net operating income by $93,000 to take into account the higher capitalization rate as recommended by Mr. Louiselle.

Conclusion

Having found the actual test year net operating income to be $34,009,000, and having discussed allowed adjustments thereto which have a total effect of increasing net operating income by $317,000, we are now in a position to ascertain the test year net operating income, i.e., the return deficiency. The test year adjusted net operating income is $34,326,000. The return requirement is $36,890,000. The difference be-

tween these figures of $2,564,000 is the return deficiency. When the income taxes to support this deficiency are added, the total company adjusted test year revenue deficiency is $5,298,000. Table V shows the computation.

Attrition

Central Maine introduced no evidence relating to attrition and made no request for an attrition allowance. The Commission Staff witness, Mr. Louiselle, did an attrition analysis, and the results of his study indicated that Central Maine would experience attrition during the first year following the estimated effective date of any rate adjustment. The attrition study done by Mr. Louiselle is similar in format to that which was done in our docket F.C. #2168, Central Maine's last rate case, and consequently need be summarized only briefly here.

In making his analysis, Mr. Louiselle projected through October 31, 1979, the growth in the major cost, revenue, and rate base items used in determining the Company's revenue requirement for the 1977 test year. Mr. Louiselle then recalculated the rate of return based on the projected figures and found that it would be less than the fair rate of return found by using test year figures. Since his analysis showed that, on the basis of his projections, attrition in the rate of return earned would occur during the first year that the test year determined rates would be in effect, the Staff recommended that an allowance for attrition be made in determining the Company's overall revenue needs.

The Commission accepts the attrition allowance concept and the method used by the Staff to account for attrition. However, it is necessary to adjust some of the numbers used by the Staff in making the calculation to account for the modifications made by the Commission in deciding this case. A year from now, projected changes in major revenues and cost items will result in a decline in the 9.48% rate of return

authorized by the Commission to 9.32%. We find, therefore, that an attrition allowance adjustment of .16% is needed to offset the projected decline. Our computations are set forth in Table IV. When the .16% attrition rate is applied to the Company's rate base, an attrition allowance increasing net operating income by $622,608 is required. With the additional revenue required to support income taxes on that amount, this means that revenues must be increased by $1,286,000 to generate the needed net operating income. Since future attrition has been established, it should be compensated for. Phillips, *Economics of Regulation,* pp. 234-244. Accordingly, we find an attrition allowance in the amount of $1,286,000 to be just and reasonable.

TABLE IV
CENTRAL MAINE POWER COMPANY
ANALYSIS OF ATTRITION AT RATE
OF RETURN OF 9.48%
DECEMBER 31, 1977 - OCTOBER 31, 1979
($1,000)

LINE NO.	ITEM	TEST YEAR AMOUNT ADJUSTED TO	TEST YEAR AMOUNT	GROWTH RATE ANNUAL RATE	GROWTH RATE COMPOUND FACTOR	TEST YEAR AMOUNT ADJUSTED TO 10/31/79
1.	Revenues	12/31/77	$193,116		Derived	$198,477
	EXPENSES:					
2.	Fuel	—	15,595	—	1.000	15,595
3.	Purchased Power	—	68,874	—	1.000	68,874
4.	Depreciation	12/31/77	14,088	3.60%	1.067	15,032
5.	Wages	4/30/79	22,882	7.25	1.036	23,706
6.	Benefits	12/31/77	2,794	7.25	1.111	3,104
7.	Payroll Taxes	4/30/79	1,578	8.60	1.043	1,646
8.	Property Tax	3/31/78	9,124	6.00	1.097	10,009
9.	Other O & M Expenses	12/31/77	14,543	6.00	1.113	16,186
10.	Total Operating Expenses		$149,478			$154,152
11.	State Income Tax	12/31/77	$ 1,360		($100)	$ 1,260
12.	Federal Income Tax	12/31/77	10,704		($645)	10,059

	OTHER INCOME					
13.	Allowance for Funds Used During Constr.	12/31/77	$ 1,947	—	Derived	$ 4,331
14.	Equity Earnings in Subsidiaries	12/31/77	3,369	7.00	1.132	3,814
15.	Net Operating Income		$ 36,890			$ 41,151
16.	Rate Base:					
	a. Net Prod. & Trans. Plant In Service	12/31/77	$156,019	—	.998	$155,706
	b. Other Plant In Service-Net	12/31/77	$166,334	7.00	1.130	187,914
	c. CWIP	12/31/77	21,888		Derived	47,127
	d. Other Rate Base Items Net	12/31/77	44,889	7.00	1.130	50,725
	e. Total Rate Base		$389,130			$441,472
17.	Rate of Return		9.48%			9.32%
18.	ATTRITION				.16%	

Allocation of Revenue Deficiency
(Jurisdictional v. Non-Jurisdictional)

Central Maine obtains revenues for services rendered under rates, tolls, and charges, some of which are subject to the jurisdiction of this Commission and some of which are subject to the jurisdiction of the Federal Energy Regulatory Commission. It also obtains revenues from rental of poles, which revenues are not approved by any regulatory commission.

The Staff contends that since the revenue requirement is a total Company revenue requirement, a portion of the deficiency should be allocated to the rates, tolls, and charges which are either subject to Federal Energy Regulatory Commission control or unregulated. We agree, of course, that Maine jurisdictional customers should only be required to have their rates increased sufficiently to cover the cost of serving them.

The Staff, based upon Mr. Louiselle's testimony and study concerning allocation of total Company revenue deficiency to Company operations beyond the Commission's jurisdiction,

has proposed that certain specific amounts be allocated to the non-jurisdictional deficiency. We have reviewed that evidence, and consistent with our findings in Central Maine's last rate case, *Re: Central Maine Power Company,* 15 P.U.R. 4th 455 (Me. P.U.C. 1976), we adopt the method underlying those allocations.

The total Company adjusted test year revenue deficiency is $5,298,000 and the total Company attrition allowance is $1,286,000. Thus, Central Maine presently needs an annual increase in revenue of $6,584,000. Of this amount, $66,000 is allocated to rates subject to the Federal Energy Regulatory Commission jurisdiction and $242,000 is allocated to pole rentals. The Maine jurisdictional revenue deficiency is, thus, $6,276,000. The computation is shown on Table V.

TABLE V
CENTRAL MAINE POWER COMPANY
DETERMINATION OF 1977 REVENUE REQUIREMENTS
(BASED ON TWELVE MONTHS ACTUAL)
($1,000)

1.	Total 1977 Operating Revenue		$ 187,582
2.	Total 1977 Operating Expenses		(148,504)
3.	Current Income Taxes		(948)
4.	Deferred Income Taxes (Including ITC of $6,724)		(9,342)
5.	Equity in Earnings of Associated Companies		3,367
6.	Allowance for Funds Used During Construction (Excluding AFUDC on Wyman #4)		1,854
7.	NET 1977 OPERATING INCOME		$ 34,009
	Adjustments To Net Operating Income:		
8.	Property Taxes	(55)	
9.	Equity Earnings	2	
10.	Rangley Run Out	(44)	
11.	Closed Out Rates	240	
12.	Wholesale Revenue Increase	38	
13.	Self Generation at Scott Paper	(242)	

14.	NEPEX Savings Fund	4	
15.	Insurance	(140)	
16.	Postage Increase	(22)	
17.	Change In State Income Tax Rate	6	
18.	Elimination of Capital Gains Tax	70	
19.	1977 Wage Increase	(179)	
20.	1978 Wage Increase	(535)	
21.	Payroll Tax Increase	(63)	
22.	Tax Effect of Capitalized Pension & Payroll Tax	102	
23.	Depreciation on Deferred Tax Reserve	314	
24.	Tax Effect of Replacement Property	376	
25.	Extraordinary Storm Damage	231	
26.	AFUDC	93	
27.	Elimination of Employee Discounts	121	
28.	Total Adjustments	317	
29.	Adjusted 1977 Operating Income		34,326
30.	Required Return (9.48% × $389,130)		36,890
31.	Return Deficiency (Line 30 - Line 29)		2,564
32.	Revenue Deficiency (Line 31 + .484) (Year ending December 31, 1977)		5,298
33.	Attrition Allowance (To October 31, 1979)		1,286
34.	Total Revenue Deficiency (Year Ending October 31, 1979)		6,584
35.	Maine Jurisdictional (Line 34 × .9899)		6,518
36.	Pole Rentals		(242)
37.	Net Maine Revenue Deficiency		$ 6,276

Wyman Unit No. 4

In this proceeding we are faced with the issue of the proper method for reflecting the effects of the new Wyman No. 4 oil-fired generating plant. This new generating unit which is to be placed in service in the near future was a part of the Company's actual construction work in progress during the test year in this proceeding. The evidence in the proceeding shows that when Wyman No. 4 is placed in service and starts to generate electricity it will have a substantial effect on the relationship of investment, return, revenues, and expenses

for Central Maine. The evidence also shows that the effect of Wyman No. 4 on the Company's revenue requirement is of such a size that failure to recognize the in-service status of Wyman No. 4 would only result in the Company's having to file an immediate request for rate relief following the placing of Wyman No. 4 into commercial operation.

In its original testimony and exhibits, the Company proposed to include in the test year one-half of the annual effect on revenue requirements of Wyman No. 4 going into service. The Staff proposed, with certain minor modifications, to extend the effect on revenues of Wyman No. 4 going into service to a full year. The Company did not object to the inclusion of a full year effect on revenues of Wyman No. 4. We find a full year inclusion to be reasonable, because it more accurately reflects the Company's revenues and expenses than a six-month adjustment would, during the period that rates set in this proceeding will be in effect.

One of the more substantial modifications made by the Staff witness to the Company's Wyman adjustment was to compute operations and maintenance expenses assuming a 50% load factor for the Wyman No. 4 plant. The Company had assumed a 60% load factor. The Company stated it had selected 60% as a load factor to reflect expenses based on what could be expected given normal operations during the life of Wyman No. 4. The Staff stated that they were interested in what the likely load factor of Wyman No. 4 would be during the period of time rates established in this proceeding would be in effect. We agree with the Staff's theory of selecting a load factor. Based on Mr. Thurlow's testimony that Wyman No. 4 may be used as a cycling unit during its early life and that in general new plants tend to have lower than average load factors, we find the Staff's estimate of a 50% load factor to be reasonable. We will adopt a 50% load factor for Wyman No. 4 computations.

The other major difference between the Staff and the Com-

pany involves the amount of property tax expense to be used when computing the income tax effects of the revenues and expenses associated with the Wyman No. 4 unit. The evidence shows that the Wyman No. 4 plant property tax expense will be $1,928,000. This amount is not in dispute. Mr. Louiselle, the Staff witness, used the full amount of $1,928,000 of property tax expense as a tax deduction when computing the income taxes. The Company used a smaller amount of property tax expense to compute income taxes in Wyman No. 4 claiming that part of the $1,928,000 in total property tax (which part had been increased and capitalized) had in fact already been deducted when computing the test year income tax expense.

The Company's complaint is more properly a question of whether the total amount of property tax capitalized which was used as a tax deduction during the test year is a reasonable amount. Even though the amount of capitalized Wyman No. 4 property tax deducted for tax purposes during the test year will now be operations and maintenance expense, the Wyman No. 4 construction work in progress will be replaced by new construction work in progress. This new construction work in progress will also have property tax deductible for computing income tax associated with it. During the test year the Company used the actual deduction for capitalized property taxes when computing test year income tax expense. The record also shows that the amount of actual construction work in progress which generated the income tax deduction will soon be equalled and exceeded by the Company. We agree with the Staff that the amount of capitalized property tax deducted for income tax purposes during the test year is as good an estimate of the future as any amount. We, therefore, reject the Company's argument and will not change the Wyman No. 4 or the test year income tax expense for capitalized property tax.

We will also use the Company's original estimate of revenues to be obtained for the sale of firm capacity associated with Wyman No. 4, since the equity rate of return appropriate in this case is close to that used by the Company in its revenue estimates. Moreover, there are no written contracts outlining the terms at which Wyman No. 4 power will be sold.

The remainder of the Staff's full year Wyman adjustment was not contested by the Company. Therefore, since we feel the full year inclusion is more appropriate, we will adopt the Staff's adjustments. Using the principles stated above and our 9.48% rate of return, we find that the Wyman No. 4 adjustment requires an increase in revenues of $9,346,000 and a jurisdictional increase of $9,252,000.

Table VI sets forth the computation.

The amount of the above revenue increase associated with Wyman No. 4 is caused by the placing of the new plant into commercial service. The Commission interprets "commercial service" to mean that Wyman No. 4 has met all the requirements of the New England Power Pool (NEPOOL) of which Central Maine is a member and that Wyman No. 4 power has been accepted for central dispatch by NEPOOL. Until the time the plant is placed in commercial service, the Company will still be accruing AFUDC on the plant and will not be incurring the expenses or receiving the revenues associated with the plant. Therefore, the Company will not be authorized to collect the Wyman-related revenues until the Commission receives from the Company a certification that Wyman No. 4 has been approved and power from Wyman No. 4 made available for central dispatch by NEPOOL.

TABLE VI
CENTRAL MAINE POWER COMPANY
W. F. WYMAN UNIT NO. 4
ANNUAL REVENUE REQUIREMENT USING A
9.48% FAIR RATE OF RETURN
($1,000)

Line No.	Item	Amount
1.	Depreciation Expense	$ 3,851
2.	Property Taxes	1,928
3.	Other Operation & Maintenance	165
4.	Inspection Costs	164
5.	Maintenance Costs at 50% L. F.	947
6.	Operating Labor	215
7.	Operating Expenses	150
	Decrease in Purchased Power:	
8.	— New England Power	(700)
9.	— Boston Edison share of MEPCO	(3,434)
	Decrease in Wheeling Expense:	
10.	— New England Power	(455)
11.	— Boston Edison	(198)
12.	Total Net Operating Expenses	$ 2,633
	INCOME TAXES AT 9.48% RATE OF RETURN	
13.	Current Federal*	143
14.	Current State*	1,016
15.	Deferred Federal	2,588
16.	ITC — Net	6,244
17.	Total Income Taxes	9,991
18.	Return at 9.48% of Rate Base	$ 11,746
19.	Total Revenue Requirement	$ 24,370
	ADDITIONAL REVENUES TO OFFSET REVENUE REQUIREMENT	
20.	Increased KWH Sales	$ 4,979
21.	Sale of 100 MW to PSC of N. H.	7,500
22.	Wheeling & Support	2,545
23.	Total Additional Revenues	$ 15,024
24.	Net Revenue Increase Required (Line 19 - Line 23)	$ 9,346
25.	Maine Jurisdictional Revenues Required (Line 24 × .9899)	$ 9,252

* Taxes computed as follows:

Revenues	$24,370
Expenses	(2,633)
Interest	(1,800)
Additional Depreciation	(5,277)
Taxable Income	14,660
State Income Tax	1,016
Federal Income Tax	6,549
Less ITC	(6,406)
Current FIT	143

Allocation of the Revenue Increase Among Rate Classes

The rates filed by Central Maine Power Company divide Maine jurisdictional customers into seven major rate classes: residential, small general service (GS-1), medium general service (GS-2), large general service (GS-3), general service transmission (GST), municipal lighting, and private area lighting. In order to realize an overall 12.5% increase in revenues, Central Maine proposed to increase revenues from the several rate classes by varying percentages, ranging from 3.7% for the GS-1 and GST classes to 17% for the residential class.

In support of this proposed allocation of the revenue increase, Central Maine submitted an original cost of service study based on 8 months of actual operating results for 1977 and 4 months of estimated operating results and on allocation factors determined from 1976 load characteristics. Pursuant to an order from the Commission, Central Maine later updated the study to include all 12 months of 1977 actual operating results and to correct a mismatch between the 1976 load characteristics and the 1977 operating results.

Central Maine's study attempts to assign responsibility to the various rate classes for the embedded costs of providing each class with service. By comparing the total plant and expenses assigned to each class with the revenues collected from each class, the Company can determine the rate of return it earns from each class of service. The proposed rates allocate the greatest portion of the revenue increase to the classes generating the lowest rate of return and the least portion to those generating the highest rate of return, as determined from the Company's original cost of service study.

The process of determining the rate of return for each class is complex. All costs are divided into one of several functions (e.g., power supply, transmission, distribution). Each of the functions is then "classified" in order to determine whether

it has demand, energy, or customer components. Finally, all costs are allocated to the various customer classes by means of allocation factors which are derived by various methods depending upon the function and classification of the cost.

A significant portion of the overall cost of providing service is classified as demand and is allocated under allocation factors which are derived from what is known as the coincident peak. Under this method of allocation, the Company assigns all power supply plant and related demand expenses based upon estimates of the contribution by each class to the single integrated one hour annual system peak.

The coincident peak method of allocation assumes that load usage during the single hour of the annual system peak is representative of customer responsibility for power supply plant and related expenses. However, as Mr. Louiselle testified:

> ". . . Where the time of the peak demand is narrowly defined and based on historical experience, it is clear that any change in the system load curve could result in a change in the time of the peak demand. Since customers are allocated costs based on such historical demands, if the time of the peak were to change even slightly, some of those responsible for the peak demand may not be bearing any of the costs. In view of this, to base cost allocation on a concept of historical peak demand, narrowly defined, constitutes a misapplication of the peak responsibility method."

When, in 1975, Central Maine first submitted its cost of service study adopting a coincident peak method of allocation, the system peak was clear and relatively well-defined. During 1975, the Company's system load exceeded 95% of the single hour peak load during only two other hours in the year. In 1976, more than half of the hours during which the system load exceeded 95% of the single hour peak occurred during the same hour of the day as the system peak. However, Central Maine's load has been shifting to such an extent

that the Commission believes that the system peak can no longer be characterized as well-defined, and slight shifts in load could easily shift the hour of system peak. During thirteen hours in 1977, the system load exceeded 95% of the single hour system peak. On only four of those occasions did the time of day coincide with the time of annual peak (December 12, 1977, hour ending at 6:00 p.m.). Any of the other nine hours, during which the demand responsibility of the various classes could have been substantially different, could easily have been the system peak hour with only minor shifts in load. Thus, the Company's cost of service study fails to assign the proper demand responsibility to those customers who may ultimately be responsible for the system peak.

Dr. John Wilson, testifying on behalf of Intervenors Keyes Fibre and Scott Paper, stated that a single hour peak method of allocation is appropriate only when that hour is representative of load characteristics during other hours in which system peak is approached. The Company has very little load data from those other hours, but what evidence is available strongly suggests that the single peak hour is not at all representative of peak demand responsibility. A study completed in 1977 of residential customers who do not use electricity for space or water heating found that those customers, as a group, reached their peak at precisely the hour of the system peak. Their average demand at that hour is more than 50% higher than their average demand during some other hours when the system load exceeds 90% of the peak hour load, which Dr. Wilson conceded might be relevant in assigning peak responsibility. Likewise, an examination of the hourly loads of the general service transmission customers reveals that the composite demand at the peak hour is substantially less than the composite demands at other hours during which system load exceeds 90% of the peak hour load. Therefore, the evidence strongly suggests that if all hours during which the system peak load is approached were considered, the allo-

cation of power supply plant and related demand expenses, and quite possibly the overall conclusions of the cost of service study, could be substantially different.

The fact that demand responsibility during the single peak hour is not representative of demand responsibility during hours approaching the peak is supported by, and perhaps partly attributable to, Central Maine Power Company's Kilowatt Savings Time program (KST). On selected days which are determined by time of year and weather conditions to be likely annual peak days, Central Maine designates 4:00 p.m. to 8:00 p.m. as KST hours. During those hours, large industrial customers are contacted directly by telephone, and other customers are urged by radio and television announcements to cut back on electrical demand. KST is intended to be a load management tool to reduce the need for additional capacity, and the program appears to have been successful during both its years of use (1976 and 1977).

There are, however, several aspects of KST which also affect relative class demands at the single hour system peak. First, it is clear that the peak hour demands of general service transmission customers are reduced significantly because of KST. An examination of composite hourly demands of those customers on the system peak day, contrasted with the composite hourly demands on a "typical weekday" (October 12, 1977), reveals that although these customers reduce their loads at or near the hour of the system annual peak, they do not make similar reductions on a typical day. Currently, only ten customers qualify for the general service transmission rate. Each of them is contacted directly by telephone during KST days, and each is capable of affecting the class demand at the peak hour significantly by shedding load. Mr. Fred J. Newhard, Chief Engineer of Scott Paper Company's Winslow plant, testified that he was personally involved in determining how much load should be taken from Central Maine, that he was "very much" aware that the single hour peak of

Central Maine is significant in the outcome of the cost of service study, and that the cost of service study is "very definitely" a factor in his decision whether to curtail demand during the system peak hour. In contrast, a residential customer who sheds load during the system peak has an insignificant effect on the overall demand of the residential class. Indeed, thousands of residential customers would have to shed load at the system peak in order to affect their class demand, because individual residential loads are small, compared to those of large industrial customers.

Second, not only are smaller customers individually virtually incapable of affecting their own power supply cost allocations, but many of those customers have never even had the opportunity to shed load during KST hours for purposes of the cost of service study. For example, the peak hour demand allocation for residential space and water heating customers is based upon a load study completed in 1974. The results of the study show how much electricity those customers demanded at the peak hour in 1974. KST was not in effect in 1974, and therefore, those customers never had the opportunity to attempt to reduce their peak hour demand responsibility during KST hours.

Finally, a contract between Central Maine and the S. D. Warren division of Scott Paper has also distorted the peak hour demand allocation to the general service transmission class. Mr. David L. Rolfe of S. D. Warren testified that by agreement with Central Maine, S. D. Warren operates one of its generators upon request during system peak hours. At the peak hour in 1976, S. D. Warren self-generated 2,500 KW, and at the peak hour in 1977, S. D. Warren self-generated 3,400 KW pursuant to the agreement. Under the agreement, Central Maine compensated S. D. Warren for the difference in energy costs between operating the generator and purchasing from Central Maine. The demand taken from the generator is not recorded on S. D. Warren's magnetic tapes

and does not appear in the composite peak hour demand of the general service transmission customers. Therefore, S. D. Warren can curtail its peak hour demand and still be made whole under the agreement. This opportunity to be compensated for curtailing demand is not available to any but general service transmission customers.

Although this contractual arrangement appears to be an effective load management tool, we must recognize that the effect of the agreement is to understate S. D. Warren's responsibility for peak demand. While S. D. Warren certainly should not be charged for the capacity which it supplies to itself, it should be noted that the energy which in theory is purchased by Central Maine and resold to S. D. Warren never is metered. Therefore, the magnetic tapes do not show S. D. Warren's true demand responsibility.

Mr. Anderson, testifying on behalf of Central Maine Power Company, claimed that regardless of whether the single peak hour is representative of other hours during which the peak is approached, capacity must be added to meet the system peak, and a determination of demand responsibility should be limited to consideration of that single one hour peak. However, we note that Mr. Anderson's assertion simply is not true. Central Maine builds generation capacity according to capability responsibility rules established as part of the New England Power Pool agreement. The rules state that a 30% weighted portion of Central Maine's generation capability responsibility is derived from the average of the 12 monthly peaks. Therefore, Central Maine does not build generation capacity solely to meet that one hour peak, and there is no logical reason to continue following blindly the single hour coincident peak method of allocation determining the revenue requirement and rate of return for the various rate classes. We find that demand responsibility can be determined more fairly if all hours during which 90% of the annual system peak is exceeded are considered.

It is clear, then, that the one hour coincident peak method of allocating demand-related costs has significant flaws. Since a large portion of Central Maine's costs are allocated to the various rate classes using this method, and since those allocated costs affect the return which the Company calculates it earns from each class, it is also clear that the flaws in the basic allocation method are magnified in this process.

The returns earned from each class of customers, as computed by Central Maine, have been the subject of much debate throughout this case. The Company's figures show returns for some classes that are above the Company's overall return, and returns for other classes that are below the overall figure. This has led to debates about cross-subsidization between classes and to requests to have any rate increase allocated so as to bring all classes closer to the overall return figure.

We find that the use of the one hour coincident peak method for allocating demand costs is so flawed and yet is so significant in the overall result of the cost of service study that we are unable to rely on the study as a basis for allocating the revenue increase among the various rate classes. Were the "90% of peak" method we have found to be fairer to be used, it is conceivable that the returns earned from the various classes would be very different from the figures the Company has presented to us. But we have no way of knowing what they would be.

Having rejected the cost of service study as a basis for allocation of the revenue increase, we are left in the position of having to make allocations without the aid of any competent cost evidence. Under these circumstances, we find that the only reasonable and fair result is to require that rates be designed so as to give all classes of service the same percentage increase over total test year revenues. *See Central Maine Power Company,* F.C. #1954 (Me. P.U.C. 1972), *Rochester Gas & Electric Corporation,* 33 P.U.R. (N.S.) 393, 524 (N.Y. Dept. of Pub. Serv. 1940).

Central Maine proposed a residential rate which continues its policy of using declining energy blocks.* We find that even if there ever was a cost justification for declining blocks, that justification no longer applies to residential customers, and, therefore, we find that the declining block structure should be eliminated from the residential class rate.

Traditionally, there have been two justifications for declining block rates: 1) not all customer costs have been recovered through the customer charge, and, therefore, the lower use energy blocks were used to recover the remaining customer costs; and 2) based on their relative demands at the time of the system peak, higher-use customers have been thought to have less demand than lower-use customers, and demand costs have been assessed in the lower use energy blocks so that lower-use customers would pay their proportionate share. (It has not yet become economically feasible for Central Maine to meter the demand of its residential customers.)

Unfortunately, Central Maine's load studies tell us very little about residential loads except at the single peak hour, and as discussed above, the single peak hour is not an acceptable method for assigning demand responsibility. However, certain information from Central Maine's load studies can be analyzed to arrive at the conclusion that higher energy use customers may in fact take relatively *more* kilowatts of demand at the time of system peak than lower-use customers. Dr. Richard Bower, testifying on behalf of the Natural Resources Council of Maine, made a study for each residential sub-class of the average kilowatt demand at the 1976 system

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* By declining energy blocks, we mean a rate structure that charges different energy rates per kilowatt hour at different levels of energy usage, with rates in the higher use energy blocks lower than rates in the lower use energy blocks.

peak hour per 1000 kilowatt hours of energy use during the month of December, 1976. The results tend to suggest that at the single peak hour, all residential customers used about the same number of kilowatts as a proportion of energy (kilowatt hour) use. Although we have rejected the use of that single peak hour as a basis for determining demand responsibility, Central Maine's load studies suggest that if a broader-based peak were used, higher energy use customers would be taking at least as many kilowatts as a proportion of energy use as lower energy use customers. As discussed above, the study of residential customers who do not use electricity for space or water heating (lower energy use customers) shows that those customers tend to peak at the same hour as the system peak. In contrast, the residential space and water heating study shows that the demand coincident with the December, 1974 system peak was considerably lower than the maximum diversified demand for that group. Furthermore, the majority of weekday peaks for those customers occurred at 8:00 a.m. during December, while the majority of system peaks occurred at 6:00 p.m. Therefore, the studies suggest that larger-use customers peak at hours other than the system peak while small customers coincide with the system peak. Viewing that information in conjunction with Dr. Bower's study concerning sub-class demands at the peak hour, the implication is clear that larger-use customers take at least as many kilowatts in proportion to kilowatt hour usage during hours within 90% of the peak hour as smaller-use customers. Thus, relative residential demand appears to increase as energy use increases.

Since the relative demands of customers in the residential class thus do not justify the use of declining block rates, the only possible justification of such a structure would be that the energy charge included some customer costs. Customer costs are defined by the Company as costs that vary with the number of customers in the rate class, regardless of energy

or demand use. These costs include such things as meter reading, billing, customer service, and the depreciation of plant such as service drops and meters, including a "minimum distribution system" consisting of a minimum amount of poles and wires needed, on average, to connect a residential customer to the Company's distribution system.

Central Maine presently charges each residential customer $3.40 per month for customer costs (often referred to as the "minimum bill"). This amount includes the right to use 25 kilowatt hours of energy at no extra charge. In this proceeding, the Company proposes to increase this customer charge to $4.00, with no energy included at all.

To the extent that the actual customer cost exceeds the customer charge, the difference has apparently been recovered in the first few blocks of the declining block rate. This means that the charge for a kilowatt hour in those blocks includes a charge for the energy itself; some charge for demand, as discussed above; and a charge for that portion of the customer cost which is not actually charged to each customer individually. Thus, as a customer's energy use progresses through the various blocks, the customer is helping to pay the actual customer cost of other customers, as well as his own. The more energy a customer buys, the more of these costs he pays.

We believe that it is crucial, if customers are to receive appropriate price signals, for customer costs to be stated separately in a customer charge, so that the energy charge reflects the actual energy and demand costs and the customer charge reflects the actual customer cost.

The Company provided a calculation of average residential customer cost of $5.68 per customer. The only serious dispute about that calculation was the inclusion of what is known as the minimum-sized distribution system. Professor Bonbright, the authority most widely cited in connection with this dispute, discussed the propriety of including these costs among customer costs:

"But the really controversial aspect of customer-cost imputation arises because of the cost analyst's frequent practice of including, not just those costs that can be definitely earmarked as incurred for the benefit of specific customers but also a substantial fraction of the annual maintenance and capital costs of the secondary (low-voltage) distribution system — a fraction equal to the estimated annual costs of a hypothetical system of minimum capacity. This minimum capacity is sometimes determined by the smallest sizes of conductors deemed adequate to maintain voltage and to keep from falling of their own weight. In any case, the annual costs of this phantom, minimum-sized distribution system are treated as customer costs and are deducted from the annual costs of the existing system, only the balance being included among those demand-related costs to be mentioned in the following section. Their inclusion among the customer cost is defended on the ground that, since they vary directly with the area of the distribution system (or else with the lengths of the distribution lines, depending on the type of distribution system), they therefore vary indirectly with the number of customers.

"What this last-named cost imputation overlooks, of course, is the very weak correlation between the area (or the mileage) of a distribution system and the number of customers served by this system. For it makes no allowance for the density factor (customers per linear mile or per square mile). Indeed, if the company's entire service area stays fixed, an increase in number of customers does not necessarily betoken any increase whatever in the costs of a minimum-sized distribution system.

"While, for the reason just suggested, the inclusion of the costs of a minimum-sized distribution system among the customer-related costs seems to me clearly indefen-

sible, its exclusion from the demand-related costs stands on much firmer ground. For this exclusion makes more plausible the assumption that the *remaining* cost of the secondary distribution system is a cost which varies continuously (and, perhaps, even more or less directly) with the maximum demand imposed on this system as measured by peak load." [Footnote omitted]

Bonbright, *Principles of Public Utility Rates,* pp. 347-48 (1961).

While we recognize the difficulties of properly allocating the costs of a minimum-sized distribution system, we find that the inclusion of these costs as customer costs is reasonable. Therefore, we accept Central Maine's calculation of its customer costs, although we will use the round figure of $5.70 for convenience and because we recognize that the calculation is, at best, a reasonable approximation of actual customer costs.

We find that the most cost-related rate structure for the residential class is one that recovers the full customer cost in the customer charge and the demand and energy costs in a uniform charge for every kilowatt-hour consumed. We find that there is no justification for continuing to use a declining block rate structure for this class. We direct Central Maine to file a residential rate with a minimum customer charge of $5.70 and a flat energy charge designed to generate the necessary revenues for the residential class.

Since a customer charge of $5.70 represents a substantial increase over the current minimum charge of $3.40, several parties in this case have criticized it as a disguised declining block rate. If each customer's bill is computed on a per-kilowatt-hour basis including the customer charge, it is true that low use customers will pay more per kilowatt hour than high use customers. However, it makes little sense to us to include the customer charge in any calculation of the cost of energy. The $5.70 simply is not a charge for the use of

energy. It is a charge designed to cover the costs of being connected to and part of an electrical system. It is no more logical to include that charge in an energy cost calculation than it would be to include the capital carrying costs of a stove, refrigerator, hot water heater, or other appliance under the theory that capital costs per kilowatt hour decrease with increased usage of the appliance.

Under the rate we are ordering here, the cost of energy, which includes demand costs, will be the energy charge. That charge will be the same per kilowatt hour regardless of the level of usage. It is our opinion that all the available cost evidence requires this result. We will require, in addition, that bills sent to residential customers inform them of the nature of all charges. The customer charge, the energy charge (including the rate per kilowatt hour), the fuel adjustment charge (including the rate per kilowatt hour), and the sales tax shall all be stated separately. The back of the bill shall include a brief description of the components of the customer charge, a brief description of the energy and demand components of the energy charge, and a definition of the fuel adjustment charge.

Central Maine argues that in the interest of rate stability, the flattening of residential energy blocks should be gradual, and the Company proposes to take some steps in that direction by reducing the number of blocks from four to three and by raising the price of the "tail" or last block by more than the other blocks. However, the evidence is clear that high-use electric space heating customers are being subsidized by other residential customers under the current rate structure. Furthermore, since 1965, the number of space heating customers has increased from 939 to 29,915. To keep electric heating rates artificially low merely compounds the problem. The greater the subsidy to those customers, the more likely it is that the number of heating customers will continue to grow. As more heating customers come on line, the subsidy

required from other residential customers will also continue to grow, as will the cost of providing facilities to generate the electricity demanded. We can find no justification for delaying the implementation of cost-based rates.

We believe that customers should pay what it costs to serve them as far as those costs can be ascertained. Some costs, of necessity, must be average costs, so there will always be some customers for whom it can be argued that the cost to serve them is above or below the average. This is inevitable, and our concern here is that the average cost be determined in a proper manner, so that the price to all customers will be as fair as possible. What is not inevitable, however, is that, where actual costs are ascertainable, some customers should receive service at a lower or higher price than others where there is no comparable difference in costs to justify it. This kind of pricing is no longer acceptable for electric rate structures, as far as we are concerned.

There is not necessarily any clear relationship, for residential customers, between the amount of income and the amount of electricity used. Despite all the well-intentioned arguments presented in this case for and against subsidies between more and less-deserving residential customers, the fact is that many people with lower incomes use large amounts of electricity and many people with higher incomes use small amounts of electricity. The reverse is also true. This being the case, even if we approved of a subsidy provided through rates, which we do not, it appears to be impossible to fashion one which would not penalize as many customers as it would assist. This is the case, whether the "deserving" customers to be subsidized are the higher-use, higher-income customers that the Company wants to recruit, or the lower-use, lower-income customers that some of the intervenors want to protect.

We are by no means unmindful of or unsympathetic to the problems faced by residential customers, large and small, in

paying and in planning for their uses of electricity. These are difficult times, economically, for people at all income levels, whether they are struggling simply to pay their electric bills or to plan how best to meet their energy needs in the future. We cannot solve the nation's economic problems, and we cannot solve ratepayers' financial problems. What we can do, however, is try to insure that those who buy electricity pay what it costs to generate and deliver that electricity to them, and that no one group of customers is subsidized at the expense of another. By doing this, we believe that all customers will be treated as fairly as possible; that they will be more able to choose wisely among competing energy technologies; that use of electricity will be neither promoted nor discouraged artificially; and that rates will, ultimately, be more stable than might otherwise be the case.

Design of General Service Rates

Most of the cost and load evidence presented to us throughout the course of this proceeding pertained to the design of residential rates and to the cost of serving the new General Service Transmission (GST) Class composed of large industrial users who take service at transmission voltage. We cannot find sufficient evidence on the record to determine whether declining block rate structures are cost-justified in the GS-1, GS-2, and GS-3 classes. Nor are we able to determine what effect changes in the customer charges in the general service classes would have on the composition of each of the classes or on the overall revenues of Central Maine Power Company. We note, however, that the customer charges in the general service classes apparently are not based upon costs.

Consequently, we will not undertake in this proceeding to prescribe a redesign of the general service rates. We do intend, however, to institute a separate investigation of the

GS-1, GS-2 and GS-3 rates and to require Central Maine, for investigational purposes, to design and submit to the Commission for its review flat energy rates and cost-based customer charges for these classes on or before January 1, 1979.

Central Maine has proposed a flat energy charge for the GST class, which includes the largest industrial users in the State. The Commission accepts the GST rate design.

Street and Area Lighting Rates

Central Maine proposed to redesign its street and area lighting rates. Because of the inefficiency of incandescent lamps as opposed to mercury or sodium lamps, the Company proposed rate decreases in the sodium lamp rates, minor increases in the mercury lamp rates, and major increases in the incandescent lamp rates.

Except for the revenue adjustments necessary because of the rejection of the Company's cost of service study and because of our findings on the overall revenue requirement, we approve of the proposed changes with two exceptions in each rate.

Although incandescent lamps are indisputably less efficient than mercury or sodium lamps, two lamps, the 58 watt and the 105 watt, are available in lower wattages than any of the mercury or sodium lamps. We find it reasonable that if a customer is satisfied by the level of lumens provided by these lower watt lamps, he should not be forced by price considerations to use more power with the higher wattage mercury or sodium lamps. Therefore, in designing substitute street and area lighting rates, the Company is directed to insure that the increase for the 58 watt and 105 watt incandescent lamps in each class does not exceed the percentage increase for the class as a whole.

Auxiliary Service, Direct Current Service and Generation Station Service

We approve of the proposed auxiliary service, direct current service and generation station service rates with the proviso that these rates should be refiled to reflect our findings on revenue requirement.

Elderly Low Income Rate

Central Maine Power Company proposed an elderly low income rate for residential customers who are at least 65 years of age, are heads of households or are principal wage earners and are presently receiving Supplemental Security Income from the Federal Social Security Administration. This rate would provide a credit of 20% on the base monthly rate (including the proposed $4.00 customer charge) for the first 500 KWH delivered.

We find that it is inappropriate for Central Maine or for this Commission to make social judgments of the nature suggested by this rate, particularly in light of the Legislature's rejection of a lifeline rate in 1977. Furthermore, there is absolutely no record evidence to support any contention that customers who would qualify for the elderly low income rate are in need of rate relief any more than other low income customers. And yet, under a subsidy of the sort here proposed, those who do not qualify to receive the subsidy are the ones who pay it through their rates. For the same reasons we discussed with respect to residential rate design in general, we feel that subsidies are inappropriate in electric rates.

Again, we understand the financial difficulties that many Maine citizens face, but we believe that these are more fairly dealt with through taxation, which is designed to reflect ability to pay, than through regulation of electric rates, which is not.

For these reasons, we find the proposed rate to be unjust and unreasonable.

Curtailable Service

Central Maine Power Company proposed to cancel its existing curtailable general service rate, and we find the cancellation to be just and reasonable. At the urging of Intervenor Martin-Marietta Corporation, the Company provided an updated curtailable rate for illustrative purposes, a rate which is apparently of no interest to any customers.

We believe that curtailable rates can be useful in load management, and we will shortly initiate an investigation, as part of our investigation of rates GS-1, GS-2 and GS-3, to determine the feasibility of offering curtailable rates to a broad group of customers. However, for purposes of this proceeding, we will not require the filing of any curtailable rates.

Time of Use Rates

Throughout this case, all parties were in agreement that the cost of providing electricity varies with the time of use. Rates which reflect these variations can serve to flatten Central Maine's system load curve and, if properly designed, can more accurately reflect the actual cost of serving each customer. Ideally, this would result in more efficient use of existing generating facilities and would postpone the need for new ones.

Central Maine proposed time-of-use rates for the residential, GS-3, and GST classes. The residential rate, limited to 500 customers, defines on-peak hours as weekdays between 8:00 a.m. and 10:00 p.m. and includes an increase above the residential customer charge of $3.50 to cover the costs of a time-of-day meter. The differential between on-peak energy charges and off-peak energy charges is approximately 3 to 1 (on-peak or off-peak). The rate is available only for those

residential customers whose usage exceeds 12,000 KWH annually.

The rates for GS-3 and GST customers define peak hours as 14 hours on weekdays between 6:00 a.m. and 10:00 p.m. (the 14 hours to be chosen by the Company). Neither rate includes any additional customer charge unless special metering facilities are required, and both rates include both demand and energy differentials. Both rates require customers to enter into a contract for two years, and the Company reserves the right to limit the number of customers served under either rate.

Dr. Wilson, testifying on behalf of Scott Paper Company and Keyes Fibre Company, presented to the Commission a proposed time-differentiated rate structure based on marginal costs which would eliminate all customer classifications. Each customer, as applicable, would be charged a customer charge, separate demand charges for capacity, transmission, subtransmission, and distribution, and separate energy charges for on and off-peak hours.

Dr. Wilson proposed, as an alternative, that time-differentiated rates be made available on an optional basis to all customers. He proposed a residential time-of-day rate with an on-peak/off-peak differential similar to Central Maine's, but with an additional charge for a time-of-day meter of only $1.25 per month.

Dr. Bower, testifying on behalf of The Natural Resources Council of Maine, proposed a mandatory seasonal rate for residential customers, designed to charge the higher cost of providing electricity during the winter months.

All parties appearing before us were in agreement that it is currently impractical to think that all customers could now be converted to rates which vary by time-of-day. The availability of metering equipment is limited and relatively expensive. All the experts testified, however, that as metering technology

improves and new meters are mass produced, costs should go down and their availability should greatly increase.

The Commission is persuaded that Dr. Wilson's proposed time-differentiated rate structure which would eliminate all customer classifications is probably the optimal rate design — and should be a target toward which the Commission's rate design decisions should be directed. However, as desirable as Dr. Wilson's rate structure may be, it simply cannot be implemented overnight. Considerations of meter availability, rate stability, uncertainty about the impact of the new design on existing classes and on individuals and firms within existing classes, and the uncertain revenue effects of an immediate switch to optional time-differentiated rates all weigh heavily against Commission implementation of his proposed structure at this time.

We reject Dr. Bower's proposed seasonal rate because we find that there is a substantial likelihood that many customers would be penalized in excess of the costs they actually impose on the system. Rates that vary by season, in conjunction with rates that vary by time-of-day, may be the best way to reflect the actual cost of service. However, there are certainly many hours during the winter months which should properly be characterized as off-peak hours. Unless and until time-of-day rates are available for all customers, a seasonal rate would unfairly charge on-peak rates for a considerable amount of off-peak use.

While we reject Dr. Wilson's rate design proposals for reaching too far, the Commission also believes that Central Maine's time-of-day rate proposals are unduly restrictive. Most of the intervenors' experts testified that the Company's proposed time-of-day rate for the residential class represented an overly cautious approach and could be made less restrictive in several ways without adverse consequences.

The Commission is cognizant of its obligations under Title 35, Chapter 4-A, the Electric Rate Reform Act, to implement

rate design proposals which "encourage energy conservation, minimize the need for new electrical generating capacity, and minimize costs of electricity to consumers." Consequently, we order Central Maine Power Company to implement its proposed time-of-day rates with the following modifications:

1) We find that the hour between 9:00 p.m. and 10:00 p.m. is not likely to be the hour of system peak. Therefore, residential peak hours should be from 8:00 a.m. to 9:00 p.m. weekdays.

2) We find that the Company can provide time-of-day service to 2,000 residential customers on a "first come-first served" basis without seriously jeopardizing its revenue estimates. The Commission does not believe the rate should be characterized as experimental because that description may have the effect of discouraging participation. Therefore, Special Condition 2 of Rate A-TD should read:

> "The Company restricts the number of customers it will serve hereunder to two thousand (2,000)."

3) In order to increase the availability of the residential time-of-day rate, service should be optional for any residential customer whose usage exceeds 6,000 KWH, rather than 12,000 KWH, as proposed by the Company.

4) The residential time-of-day customer charge should be recalculated to provide for the proper differential above the $5.70 residential customer charge discussed above. The costing method used to price time-of-day meters in the monthly customer charge should be the same as that used to calculate the capital and operating costs of ordinary residential meters.

5) No GS-3 or GST customer may be denied time-of-day service under the clauses reserving the right to limit service, without the approval of the Commission. The tariffs should be revised accordingly.

6) The Company shall provide us with copies of the stan-

card contract required for service under the GS-3 and GST time-of-day rates.

7) All of the time-of-day rates should be recalculated to reflect the overall revenue requirements of the respective classes.

Therefore, it is

ORDERED

1. That the following rate schedules filed by Central Maine Power Company on January 16, 1978 are unjust and unreasonable, and the same are hereby disallowed, rejected and shall not become effective:

Rate A, Sheets 1 and 2, Eighteenth Revision;
Rate AL, Sheets 1 and 2, Second Revision;
Rate AL, Sheet 3, First Revision;
Rate AL, Sheet 4, Cancellation;
Rate GS-1, Sheets 1 and 2, Third Revision;
Rate GS-2, Sheets 1 and 2, Third Revision;
Rate GS-3, Sheets 1 and 2, Second Revision;
Rate M-3, Sheet 1, Sixth Revision;
Rate N, Sheet 1, Tenth Revision;
Rate SL, Sheets 1, 2, and 3, Second Revision;
Rate SL, Sheet 4, Cancellation;
Rate A-ELI, Sheets 1 and 2, Original;
Rate A-TD, Sheets 1 and 2, Original;
Rate GS3-TD, Sheets 1 and 2, Original;
Rate GSS, Sheets 1 and 2, Original;
Rate GST, Sheets 1 and 2, Original;
Rate GST-TD, Sheets 1 and 2, Original;

2. That the cancellation of Rate CGS may become effective.

3. That the following changes in the Rules and Regulations may become effective as filed on January 16, 1978:

Section 4, Sheet 4, Eighth Revision;

Section 13, Sheet 13, Eighth Revision;
Section 14, Sheet 14, Fourth Revision;
Section 18, Sheet 18-E, Fourth Revision;

4. That Central Maine Power Company is authorized to file a new schedule of rates, tolls, and charges consistent with this opinion and designed to generate an increase in gross revenues of no more than $6,276,000 over adjusted test year gross revenues. These new schedules shall not become effective until reviewed and approved by the Commission. At the time the Company files revised schedules pursuant to this paragraph and paragraph 5 it shall file underlying worksheets proving the revised schedules generate the revenues authorized.

5. That upon presentation to the Commission of a certificate that Wyman No. 4 has met the requirements of NEPOOL and that power from Wyman No. 4 is available for central dispatch from NEPOOL, Central Maine Power Company is authorized to file a new schedule of rates, tolls, and charges consistent with this opinion and designed to generate an additional increase in gross revenues of no more than $9,252,000 over adjusted test year gross revenues. These new schedules shall not become effective until reviewed and approved by the Commission.

6. That the substituted rate schedules filed pursuant to paragraphs (4) and (5) above be designed so that all rate classes receive the same percentage increase over total test year revenues.

7. That Rate A, the residential rate, be designed to include a customer charge of $5.70, with the remainder of required base revenues from the residential class to be collected through a single energy charge which does not vary with the level of energy use.

COMMISSIONER SMITH: (Concurring in part, dissenting in part on revenue requirements; dissenting on rate design)

8. That on or before January 1, 1979, all bills to residential customers are to state separately the customer charge, the energy charge (including the rate per kilowatt hour), the fuel adjustment charge (including the rate per kilowatt hour), and the sales tax. The back of the bill shall include a brief description of the components of the customer charge, a brief description of the energy and demand components of the energy charge, and a definition of the fuel adjustment charge.

9. That rates GS-1, GS-2, GS-3, M-3, N, GSS, and GST be designed internally as they were proposed with appropriate changes for differences in the revenues required from each class.

10. That rates A-TD, GS3-TD and GST-TD be designed and filed as discussed in the body of this opinion.

11. That rates AL and SL be designed as discussed in the body of this opinion.

Dated at Augusta, Maine, this 13th day of October, A.D., 1978.

BY ORDER OF THE COMMISSION

Rachel A. Johnson

Rachel A. Johnson
Assistant Secretary

A true copy.
Attest: Rachel A. Johnson, Assistant Secretary

COMMISSIONERS VOTING FOR: Gelder
Carrigan

COMMISSIONER SMITH: (Concurring in part, dissenting in part on revenue requirements dissenting on rate design:*)

On revenue requirements, I agree or acquiesce in the Commission order, subject to three important exceptions noted below. These three items should be added to the rate base and/or to revenue requirements. A total of $250,000 is to compensate for the disallowance on employee discounts; $241,015 added for land held for future use; and the sum of $648,000 for depreciation on plants financed by deferred income taxes. Accordingly, the evidence supports a total of $1,145,015 added to the revenue requirements of the Company.

It is noted paranthetically for clarification that the portion of the decree on alleged political advertising used from August 1 through 24, 1978 does not pertain to this rate case and the test year of 1977. In any event, I consider this more institutional than political advertising.

Employee Discounts

By legislative enactment this Commission has discretion to allow or disallow employee discounts for rate-making purposes — a topic much in dispute, especially for regulated endeavors. For many years this agency has approved such benefits. I see nothing unreasonable here to warrant reversal. Now, more than ever, it seems unfair to change this policy, particularly for retired employees living on fixed in-

* Practically the entire Commission concentrated on the majority decision, while this Commissioner, without a satisfactory assistant, works virtually alone. Consequently this is merely a hasty outline of differing views, necessarily without documentation. The public has a right to know that the Commission order on intervenors went out on March 17, 1978 before I had opportunity to see it and write comments thereon. Likewise, no time was available to study, or even read, the final decision in this case.

comes. My plea to postpone action until the next rate case in order to ascertain for the record the amount of money involved in favor of retired individuals went unheeded. The contention that discounts encourage waste of electricity is not convincing. The disagreement on this issue is a matter of policy — not law. I would add $250,000 to the revenue requirement here.

Rate Case Appeal Expenses

The Commission was unanimous in its handling of appeal expenses in the last Central Maine rate case. But there was no consensus on the rationale. One effect of a dissent is to weaken the potency of the decree as a precedent — one of the trio is unconvinced in whole or part. It is similar to a court decision which lacks unanimity. A dissent is virtually an invitation to appeal the decision to higher authority.

Depreciation on Plant Financed By Deferred Income Taxes

I offer a strong dissent on the issue of depreciation on plant financed by deferred income taxes. This is in conformity with my stand in the last New England Telephone Company rate case on depreciation for federal income taxes — a position sustained by the Law Court. In the telephone rate case, the majority of the Commission disallowed large sums of federal tax expense. Less money is involved here, because the issue is limited to depreciation. The contention that this money is customer-contributed capital can be argued both ways, but to me the conclusion is far-fetched. Although the current issue is not identical it is an offshoot from the decree in F.C. #2213, and emblematic of the same ideological approach. Here again, the majority decision puts the Company at an undue disadvantage in raising capital. I see no real difference between the situation here and in the telephone remand decision, and conclude that the Commission decisions in both constitute violation of national economic policy.

This may well be an attempt by the Commission to whittle away at the effect of the remand decision. Consistent with my stand in F.C. #2213, I disagree with the majority on this issue as to policy and as to law as I understand it. To this end, a total of $648,000 should be added to the revenue requirement.

Land Held for Future Use

In general I accept the Staff recommendations on disposition of the issues on land held for future use; but reject the decision of the majority to go beyond that recommendation. The final verdict is not substantiated in the record, and it is unrealistic for 1978. Furthermore, the accusation that my stand gives the Company a free hand to buy up and hold land indefinitely is entirely incorrect.

It should be remembered that, as the demand for electricity increases, and as size and technologies of new plants and projections become more complex, astute corporate management must plan ahead today far beyond their 1950 standards. Acquisition of land for generating plants often must be acquired sometimes now or never. The land cannot be taken under eminent domain in Maine.[1] Consequently delay in acquisition of land today may mean purchase at an exorbitant cost later. Often there is insufficient land available today for

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[1] The Supreme Judicial Court of Maine took a very narrow view of use of eminent domain and distributing electricity in 1905. *Brown v. Gerald*, 100 Maine 351—a decision out of line with leading federal holdings. Subsequently, the doctrine was somewhat liberalized in 1926, when the Court limited *Brown v. Gerald* to its own particular facts, and allowed the condemnation of land for *transmission* of electricity for both light and power purposes. *Smith v. Power Company*, 125 Maine 238 (1926).

special facilities. Corporations need an incentive to make the purchases whenever they can. Even if a reasonably plausible purchase subsequently turns out unsuitable for future use, a company should not be penalized unless it is clear that the acquisition was imprudent, visionary, or made in bad faith. The presumption belongs with corporate management, and the Commission has the obligation to prove it unreasonable. The record shows, beyond a shadow of doubt, that all disputed lands are definitely tied into very specific and well publicized proposals actively pursued by Central Maine for future generation stations. At this stage one would need to be a clairvoyant or soothsayer to state if and when these aspirations will become realities. Whenever a plant will be completed and go on the line today is largely a matter of speculation among the experts.

Planners now are confronted with accelerated obstacles in steering their projections through legal requirements relating to conservation, safety, aesthetics, and environmental considerations, often at both national and state levels, and sometimes local as well. Lengthy and complex construction requirements add to the dilemmas. The initiative for such purchases rests with corporate management.

States vary on handling the issues involved in land held for future use for generating purposes. In the absence of reliable data on the Maine situation, my preference is to follow the lead of the Federal Power Commission (FERC) which has rules on accounting, making such allowances for the federal government and wholesale rates — eventually going back to ratepayers. Likewise gains and losses in settling or disposing of these lands belongs to ratepayers.[2] The suggestion that if the Commission is wrong, "let them come in with a rate case" offends my sense of public responsibility.

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[2] FPC Order 420, Docket R. 379, January 1971; Order 420-A, February 1971.

A special note is in order for the Stockton Springs land, because the situation is more complicated than that at Richmond and Sears Island. Unlike the others, the contemplation here is that the land will be used both for a generating station and transmission lines. It is not known if ownership will be held jointly, some allocations may be justified between this and Sears Island, and the approximate date of completion is necessarily uncertain at this time. The staff included this project in the rate-base calculations. The Commission makes further assumptions without critical appraisal after the hearings were closed. These are unclear in my mind, so the original staff recommendation is supported in this dissent.

The Commission is groping for a standard to impose on management as a line of demarcation of what land purchases are reasonable and what are not; and to shift the burden of proof on the Company. If a formula can be developed, it would, in my opinion, require a generic hearing with opportunity for experts to testify before a result could be promulgated in a general order with widespread applicability. To proceed on a case by case basis as indicated would require expert field work and investigations of every parcel of land involved — a task for which this Commission lacks staff and expertise. A desk job would be entirely inadequate.

Companies already are required to furnish data on the need and logic for their land purchases for future generating use. Then it is the obligation of the Commission, before disallowance, to prove the purchases were unnecessary, unwise, unreasonable, made in bad faith or other attributes to inefficient management. This proof has not been presented here.

In approving the adjustments of the staff on land held for future use, as opposed to the decisions of the majority, the Richmond properties representing $665,549 and the Stockton Springs properties representing $492,350 should be added to the rate base. The staff adjustment for Sears Island is $713,449, as opposed to the Commission reduction to

$610,213. Accordingly, the staff proposal of a total of $1,871,348 should be included in the rate base for the three projects. This is in contradistinction to the actual amount of $610,213 the Commission put into the rate base. This is calculated as a revenue requirement over and above the amount found by the Commission by a sum of $247,015.

In this case also, the burden of proof is on the Commission when it makes further adjustments and lowers the recommendations of our regular staff and those of our outside consultants hired at a cost of $50,000 of taxpayers' money.

Curtailable Rate

Several participants in Commission deliberations on September 26 displayed uncertainties on the above topic, and some staff members were reluctant to advise a broad investigation. It was agreed unanimously that the curtailable rate as filed would be disallowed at this time. It was urged that the Commission set forth general guidelines of objectives on what we would like to accomplish. The next step would be to instigate a proceeding. Some wanted it patterned after standby rates, put load management in a more important context, establish guidelines even though incorrect ones, put the burden on the Company to make the filing, perhaps make our own curtailable rate in terms of money, and perhaps extend the investigation to general service rates as well. I opposed such a miscellaneous investigation. However, the concept is heartily endorsed, but not the broad investigation anticipated.

Time of Day Optional Experiment

A limited and controlled time-of-day program is heartily approved on an experimental basis. The Company is to be applauded for presenting such a venture for our consideration.

But I cannot approve the drastically enlarged program set up in this decree. Here again, I consider this order extended beyond reasonable and controllable bounds, grossly speculative, untimely, ordering risks with other people's money, and established without any figures or reliable estimates in the records on likely impact on all parties concerned.

I toyed with the advisability of enlarging the Company's suggested 500 customers to 1,000. But the decision puts the number at 2,000, quadruples the subjects originally intended, and extends the financial gamble to one-third of a million dollars. The Company opined that probably not more than 500 meters will be available at the outset. The order to require the Company to recalculate the meter cost produces no tangible result at this time. The decision to reduce customer usage from 12,000 to 6,000 kilowatt hours to get into the program is another figure selected without recorded validity. The assumptions made here came after the hearings, and did not withstand cross-examination from Company and Intervenors or by this Commission. My idea is that a limited experiment directed to areas in which we can secure empirical data and learn from experience would be valuable for the concept as well as for the public.

It is entirely correct that the Commission does not at this time know what it desires to ascertain on the subject. The suggestion that we obtain expert assistance from the National Regulatory Research Institute is welcomed though belated for this order. That is exactly why I do not want to plunge at this time into something so uncertain. This simply is a difference in philosophical approach, neither one of which can be adjudged correct — unless the evidence in the record substantiates this particular structure as ordered. The Commission unanimously endorses the concept; the opposition is to its implementation.

Flat Rates

I doubt if this electric system can adjust equitably to such a radical change to flat residential rates, particularly when insufficient attention has been given to the impact on all customer classes and on the system. This verdict orders risks amidst speculation and imponderables at this time. If the change must be made, rather than plunge in this far, I would prefer a more moderate approach after careful analysis and greater attention to alternative solutions and probable results. With lack of insight on probable results of revenue which can be collected from flat rates, it may well be that Company coffers will rise beyond reason. Now nobody knows. Refunds are not permissible under Maine law.

Flat rates are useless to track costs and are therefore irrelevant when one attempts to base rates on cost of service. That is essentially why the newer declining blocks became ascendant, because they are cost justified.[1] This, then, is in accord with the legislative directive to base rates on cost of service. Conversely, declining block rates are not promotional. Under the proposed flat rate order, high load factor customers pay more than their fair share of the demand costs, whereas low load factor customers pay less. Under the formula adopted by the majority, a rate for anything that tracks actual cost would be deemed promotional, because, in general, costs per unit decline as units of output increase.

Considerable thought was given to the pros and cons that declining block rates discourage conservation of electricity. My first concern, however, is that declining blocks are roughly commensurate with cost of service. Quantity discounts are commonplace, because they reflect actual savings

[1] See; W. Donham Crawford, "An Electric Utility Perspective on Rate Design Revision." *Public Utilities Fortnightly,* September 14, 1978.

in costs to serve. To argue otherwise, oversimplified, is to argue that two and two make five. The stability factor lauded by a great majority of the witnesses also requires recognition. Widespread interest in this case shows clearly that ratepayers are highly conscious of their utility bills, which currently take up a large portion of incomes, especially from fixed and low-income groups. Not many people will use more electricity than they need because the increments are cheaper, any more than a man who needs only one car will buy two or three because they are a little cheaper. Penalty rates several years ago by higher prices on gasoline, for example, had little effect on conservation of gas. The logical way to comply with the legislative directive and promote conservation is through proper pricing and allocating of cost responsibility. In short, the highly important conservation factor becomes secondary to the cost factors.

Against my vote, the oil dealers were permitted to intervene and attack their competitors in electric space heating. On the other hand, customers for electric space heating are unorganized, unrepresented, lacked intervention and appeal privileges, and were unable to present their views to the Commission with full force. Their *rights,* however, are entitled to recognition. Moreover, the Commission ought to be concerned with any conservation program which might help to lessen our dependence on foreign oil.

On several occasions the Commission discussed an appropriate monthly customer charge for residential users, currently set at $3.40. Experts had recommendations varying from $1.50 to $5.68. The outcome, 2 to 1, was for the highest figure (taken from the cost of service study), rounded up to $5.70.[2] Compared with present fees, this seems a bit regressive in that it means an increase of 68 percent on the smallest

[2] In deference to the stability factor, my preference was for a $4.00 compromise.

residential users (25 kilowatt hours or less) for customer charge alone, i.e., an annual increase from $40.80 to $68.40. It is only fair to indicate, however, that the percentage increment decreases with higher utilization of electricity and thus becomes more palatable; and that when coupled with flat rates the customer charge may not be very meaningful. It still remains, however, that the extremely high customer charge adopted will render a hardship on small users, and particularly on seasonal customers who must pay every month without any use of electricity whatsoever.

Finally, one may well take issue with the concluding sentence in the subtopic on design of residential rates that there is no justification for delaying the implementation of cost based rates. This statement is in conflict with the proposed flat rate order, since it does not determine demand-cost responsibility for the residential class. The order does not recognize that there is any cost related to demand for the residential class. This discriminates against the general service class, where demand charges are being imposed.

It is unfortunate that one witness under oath is accused in the decree of an asserted untruth. The issues of single peak hour and demand responsibility were argued at length in the hearing. Honest differences of opinion emerged. Insufficient findings of fact are presented in the decree to support this conclusion: "We find that demand responsibility can be determined more fairly if all hours during which 90% of the annual system peak is exceeded are considered."

The decision of the Commission to order across the board increases over the total test year revenues as a substitute for the cost of service study is rejected here. It is a subjective judgment, without adequate findings of fact — an improvisation which perpetuates existing inequities.

*Rate Design**

I reject the entire Rate Design presented above, not only because it fails to produce the revenue to which the Company is entitled in law and equity (exceptions to the revenue requirement previously noted), but also because it is arbitrary, unreasonable, and not in accord with the testimony in the case. On two or three occasions, in order to avoid possible three-way splits on issues, I voted for the lesser of two evils in order to cooperate and provide the Commission with a working majority. In the final analysis, there is virtually nothing significant in the rate design appealing to my concept of the public interest.

The Commission devoted long and sometimes arduous hours in public session on rate design, issue by issue. But the deliberations ceased before the Commission attempted any final evaluation of its end product. Here the result is equal to *more* than the sum of its component parts — all items need to be considered in perspective as an entity before being promulgated into an order of this magnitude.

At the conclusion of the last Central Maine rate case two years ago, the Commission instituted an important study by creating an electric rate structure reform group — U. #3245. But after one meeting it fizzled out, as the Commission expanded its activities in other directions considered by me

* Unfortunately, all rate making is discriminatory—some classes will gain and others will lose. The quest of a regulatory tribunal is to obtain a rate structure which is not *unduly* discriminatory—a balance based on law, fact, and value judgments of Commission expertise. In my opinion the Commissioners were at a great disadvantage during deliberations on rate design. Our outside consultants were hired for revenue requirements only. The regular staff presented no testimony, and consequently had little input in the hearings. To me, rate structure is more a technical matter than a legal one.

tangential to several high priority problems, including rate reform. Now the Commission is confronted with much the same predicament and without the significant spade work which might have been achieved under continued Commission auspices.

The Commission tackled rate design once again with enthusiasm and imagination. Several intervenors were interested in this part of the rate case only. A maze of grossly particularistic testimony was presented from all sides, influencing this Commissioner with varying degrees of expertise and plausibility. No consensus was anticipated, but many witnesses agreed, some reluctantly, that the Company plan was far superior to its presentations in recent rate cases. This Commissioner argued unsuccessfully that the Company program warranted primary consideration, but also critical analysis. Some objectivity could be anticipated. Bases: On rate design the Company's revenue requirements already had been determined, and therefore the Company had relatively little to lose financially from its projections. Its staff is intimately familiar with Maine problems and singularly familiar with customer responses, experienced in operations, and had devoted more time and expertise to alternative solutions and impacts thereon. Except for its suggestions on street lighting, this appraisal was reasonably satisfactory to me. Early doubts on hourly curtailable rate provisions were resolved adequately in rebuttals.[1]

On several occasions during deliberations blank spots in information were discovered, and need for additional data from the Company was expressed. Once or twice the advisability of opening the record was discussed as a result of afterthoughts within the Commission. It is unfortunate that

[1] This is not presented as a truism. If unscrutinized, a ruthless corporation could neglect innovation and conservation, for example.

numerous assumptions were made without verification, cross-examination, and without assistance from anybody experienced in operations. The ability of the Company to request reconsideration of the decree was suggested as a way to rectify errors, if any are found.[2]

The Commission edict on rate design violates the guidelines set forth by the Supreme Judicial Court, as I interpret it, in the remand in F.C. #2213. Rejection of proposed schedules are tenable only when the Commission shows specifically 1) where and how the rate design is unreasonable and unjust; and 2) that all alternatives therefor are supported by substantial evidence in the record. In the event of wholesale change, such as in this instant, some correlation seems necessary to show that the Commission's rate design will approximate the new revenue requirements established by it.

The Commission's duty, as I see it, is to exercise its discretion for alterations, and return the document to petitioner with guidelines and amplifications for improvement in accordance with current Commission guidelines. The Company has requested this of the Commission. But I cannot accept the straight-jacket composite ordered here — without greater insight on its outcome on ratepayers of all classes and the Company.

The initiative and major responsibility for presenting a rate design is with the Company. The other extreme, according to one authority, may invite charges of expensive, bureaucratic regulation which taxpayers cannot afford.[3] The Company's proposal includes with it, a rebuttable presumption as a prerogative of corporate management. The keynote is that the Commission has the burden, before rejection, to prove the document is unjust and unreasonable.

[2] This is based on my copius notes, and undoubtedly substantiated by the unofficial tapes of Commission deliberations.

[3] See: W. Donham Crawford, *loc. cit., Supra,* p. 15.

Rate design is based initially on informed judgment of the experts who make it. Other experts, as expected, have disagreed. The Commission may alter the original presentation to adopt the views of outside experts. Whenever the adjustments are made, however, the Commission needs to point out where and how the choices were made, why, that they are not arbitrary, plug in the other information utilized, and ascertain alternative results to make its case. Whether or not the Commission and/or intervenors have other subjective *preferences,* the controlling factor initially is the reasonableness of the plan presented. A design may be entirely reasonable even though other individuals consider it unwise.

The Commission, to be sure, has latitude in the exercise of its discretion to alter or reject unreasonable Company proposals, and to substitute its own. In the words of the Court: "We will not interfere with its (Commission) decision if the result is reasonable and its findings are supported by substantial evidence."[4] This suggests a three-point progression: 1) ". . . a finding that the schedules proposed by a public utility are unjust, unreasonable, insufficient, unjustly discriminatory, or otherwise in violation of law.";[5] 2) that the improvised order is reasonable; 3) that the findings are supported by substantial evidence. This has not been done.

Some generalizations but no specific reasons were expressed during deliberations on bases for taking a stand on the cost of service study. The strategy is to make no outright rejection of the Company's schedule, but to use it in some areas and put no reliance on it in others. A big question was how it could be modified and yet substain appeal. Use of platitudes and equivocal language does not make it more palatable to this Commissioner. The repudiations and alterations constitute, in my opinion, rejection of the Company study. Here the Commission's fragmentations mean that it ceases to be a cost of service study. The remnants of the original schedule are virtually unrecognizable in the context of the Commission's order. In the final analysis it approximates: "throw out what you dislike, and retain what you like."

[4] New England Telephone Company remand decision, June 28, 1978 (mimeo.), p. 142.

[5] *Ibid.,* p. 141.

The suggestion that the Commission set out specific requirements for future studies is applauded; but it ought to include collaboration with outside experts. The controversial allegation that industrial and commercial customers are responsible for the increasing demands for electricity and for new and expensive construction projects has not been sustained to my satisfaction by the evidence in the case. On the contrary, the indications are that industrial and commercial concerns are, in effect, subsidizing other classes at present.

What Now?

Consistent with my views on rate structure techniques in the last New England Telephone Company rate case F.C. #2213 (the Court did not rule on that rate structure) this is a hasty capsulization of major reasons for rejecting the Commission decree. Amplification would constitute a brief for the Company — which is not the function of a dissenting Commissioner. To attempt to present a constructive rate structure alone would be presumptive.

Wholesale and sudden upheaval in a rate structure is contrary to one of the basic tenets presented by one of the greatest authorities and scholars in this field — that rate stability is one of the eight conditioning factors for a sound rate structure.[1] If sustained, and this rate order becomes pre-

[1] James C. Bonright, *Principles of Public Utility Rates* (New York, 1961), pp. 291 ff. Of his eight complementary items this one seems to have been honored in the breach: "Stability of the rates themselves, with a minimum of unexpected changes seriously adverse to existing customers . . ."

cedent and is extended (with adjustments) on a case by case basis throughout the State, it may be an injustice to ratepayers in central and northern parts of Maine who had no input in this significant and perhaps landmark decision. A more equitable solution would call for more widespread geographic representation and testimony in a generic hearing — perhaps prior to the issuance of a general order. In any event, I again urge the Commission to reactivate proceedings in U. #3245 — still on our Docket — after a lapse of two years. I recommend that it be given a high priority in our activities for Commissioners as well as staff.

/s/ Lincoln Smith
Lincoln Smith
Commissioner

Appendix C.

26 U.S.C. § 167*(l)*

(l) Reasonable Allowance in Case of Property of Certain Utilities.—

(1) Pre-1970 public utility property.—

(A) In general.—In the case of any pre-1970 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(i) a subsection (1) method, or

(ii) the applicable 1968 method for such property.

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

(B) Flow-through method of accounting in certain cases.—In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—

(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

(2) Post-1969 public utility property.—In the case of any post-1969 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(A) a subsection (1) method,

(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

(C) the applicable 1968 method, if with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

(3) Definitions.—For purposes of this subsection—

(A) Public utility property.—The term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of—

(i) electrical energy, water or sewage disposal services,

(ii) gas or steam through a local distribution system,

(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(iv) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(B) Pre-1970 public utility property.—The term "pre-1970 public utility property" means property which was public utility property in the hands of any person at any time before January 1, 1970.

(C) Post-1969 public utility property.—The term "post-1969 public utility property" means any public utility property which is not pre-1970 public utility property.

(D) Applicable 1968 method.—The term "applicable 1968 method" means, with respect to any public utility property—

(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

(iii) if neither clause (i) nor (ii) applies; a subsection (1) method.

In the case of any section 1250 property to which subsection (j) applies, the term "applicable 1968 method" means the method permitted under subsection (j) which is most nearly comparable to the application 1968 method determined under the preceding sentence.

(E) Applicable 1968 methods in certain cases.—If the taxpayer envidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (1) method) with respect to any public utility property in a timely application for change of accounting method filed before August 1, 1969, or in the computation of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 accounting period, such other method shall be deemed to be its applicable 1968 method with respect to such property and public utility property of the same (or similar) kind subsequently placed in service.

(F) Subsection (1) method.—The term "subsection (1) method" means any method determined by the

Secretary to result in a reasonable allowance under subsection (a), other than (i) a declining balance method, (ii) the sum of the years-digits methods, or (iii) any other method allowable solely by reason of the application of subsection (b)(4), or (j)(1)(C).

(G) Normalization method of accounting.—In order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

(H) Flow-through method of accounting.—The taxpayer used a "flow-through method of accounting" with respect to any public utility property if it used the same method of depreciation (other than a subsection (1) method) to compute its allowance for depreciation under this section and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

(I) July 1969 accounting period.—The term "July 1969 accounting period" means the taxpayer's latest accounting period ending before August 1, 1969, for which it computed its tax expenses for purposes of reflecting operating results in its regulated books of account.

For purposes of this paragraph, different declining balance rates shall be treated as different methods of depreciation.

(4) Special rules as to flow-through method.—

(A) Election as to new property representing growth in capacity.—If the taxpayer makes an election under this subparagraph before June 29, 1970 in the manner prescribed by the Secretary, in the case of taxable years beginning after December 31, 1970, paragraph (2)(C) shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3)(A) and does not represent the replacement of existing capacity.

(B) Certain pending applications for changes in method.—In applying paragraph (1)(B), the taxpayer shall be deemed to have used a flow-through method of accounting for its July 1969 accounting period with respect to any pre-1970 public utility property which it filed a timely application for change of accounting method before August 1, 1969, if with respect to public utility property of the of the same (or similar) kind most recently placed in service, it used a flow-through method of accounting for its July 1969 accounting period.

(5) Reorganizations, assets acquisitions, etc.—If by reason of a corporate reorganization, by reason of other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, orby reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purpose of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

Addition.—Sec. 167(*l*) was added by Sec. 441(a) of Public Law 91-172, Dec. 30, 1969 (qualified effective date rule in Sec. 441(b) of P.L. 91-172). Sec. 167*(l)* as so added is in P-H Cumulative Changes.

26 C.F.R. § 1.167(l)

§ 1.167(l) Statutory provisions depreciation; public utility property. [Sec. 167(*l*), IRC]

§ 1.167(l)-1 (T.D. 7315, filed 6-6-74.) Limitations on reasonable allowance in case of property of certain public utilities.

(a) *In general*—(1) *Scope.* Section 167 *(l)* in general provides limitations on the use of certain methods of computing a reasonable allowance for depreciation under section 167(a) with respect to "public utility property" (see paragraph (b) of this section) for all taxable years for which a Federal income tax return was not filed before August 1, 1969. The limitations are set forth in paragraph (c) of this section for "pre-1970 public utility property" and in paragraph (d) of this section for "post-1969 public utility property". Under section 167*(l)* a taxpayer may always use a straight line method (*or* other "subsection *(l)* method" as defined in paragraph (f) of this section). In general, the use of a method of depreciation other than a subsection *(l)* method is not prohibited by section 167*(l)* for any taxpayer if the taxpayer uses a "normalization method of regulated accounting" (described in paragraph (h) of this section). In certain cases, the use of a method of depreciation other than a subsection *(l)* method is not prohibited by section 167*(l)* if the taxpayer used a "flow-through method of regulated accounting" (described in paragraph (i) of this section) for its "July 1969 regulated accounting period" (described in paragraph (g) of this section) whether or not the taxpayer uses either a normalization or a flow-through method of regulated accounting after its July 1969 regulated accounting period. However, in no event may a

method of depreciation other than a subsection *(l)* method be used in the case of pre-1970 public utility property unless such method of depreciation is the "applicable 1968 method" (within the meaning of paragraph (e) of this section). The normalization requirements of section 167(l) with respect to public utility property defined in section 167*(l)*(3)(A) pertain only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight line depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Regulations under section 167*(l)* do not pertain to other book-tax timing differences with respect to State income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items. The rules provided in paragraph (h)(6) of this section are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated methods of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer's regulated books of account. The formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the tax-

payer. The formula serves to limit the amount of such disallowance.

(2) *Methods of depreciation.* For purposes of section 167*(l)*, in the case of a declining balance method each different uniform rate applied to the unrecovered cost or other basis of the property is a different method of depreciation. For purposes of section 167*(l)*, a change in a uniform rate of depreciation due to a change in the useful life of the property or a change in the taxpayer's unrecovered cost or other basis for the property is not a change in the method of depreciation. The use of "guideline lives" or "class lives" for Federal income tax purposes and different lives on the taxpayer's regulated books of account is not treated for purposes of section 167*(l)* as a different method of depreciation. Further, the use of an unrecovered cost or other basis or salvage value for Federal income tax purposes different from the basis or salvage value used on the taxpayer's regulated books of account is not treated as a different method of depreciation.

(3) *Application of certain other provisions to public utility property.* For rules with respect to application of the investment credit to public utility property, see section 46(e). For rules with respect to the application of the class life asset depreciation range system, including the treatment of the use of "class lives" for Federal income tax purposes and different lives on the taxpayer's regulated books of account, see § 1.167(a)-11 and § 1.167(a)-12.

(4) *Effect on agreements under section 167(d).* If the taxpayer has entered into an agreement under section 167(d) as to any public utility property and such agreement requires the use of a method of depreciation prohibited by section 167*(l)*, such agreement shall terminate as to such property. The termination, in accordance with this subparagraph, shall not affect any other property (whether or not public utility property) covered by the agreement.

(5) *Effect of change in method of depreciation.* If, because

the method of depreciation used by the taxpayer with respect to public utility property is prohibited by section 167*(l)*, the taxpayer changes to a method of depreciation not prohibited by section 167*(l)*, then when the change is made the unrecovered cost or other basis shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time.

(b) *Public utility property*—(1) *In general.* Under section 167*(l)*(3)(A), property is "public utility property" during any period in which it is used predominantly in a "section 167*(l)* public utility activity". The term "section 167*(l)* public utility activity" means the trade or business of the furnishing or sale of—

(i) Electrical energy, water, or sewage disposal services,

(ii) Gas or steam through a local distribution system,

(iii) Telephone services,

(iv) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(v) Transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in section 167*(l)*(3)(A). The term "regulatory body described in section 167*(l)*(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a pubiic service or public utility commision or other body of any State or political subdivision thereof similar to such commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undistrubed rates filed by the taxpayer involved.

(2) *Classification of property.* If property is not used solely in a section 167*(l)* public utility activity, such property shall be public utility property if its predominant use in a section 167*(l)* public utility activity. The predominant use of property for any period shall be determined by reference to the proper accounts to which expenditures for such property are chargable under the system of regulated accounts required to be used for the period for which the determination is made and in accordance with the principles of § 1.46-3(g)(4) (relating to credit for investment in certain depreciable property). Thus, for example, for purposes of determining whether property is used predominantly in the trade or business of the furnishing or sale of transportation of gas by pipeline, or furnishing or sale of gas through a local distribution system, or both, the rules prescribed in § 1.46-3(g)(4) apply, except that accounts 365 through 371, inclusive (Transmission Plant), shall be added to the accounts enumerated in subdivision (i) of such paragraph (g)(4).

(c) *Pre-1970 public utility property*— (1) *Definition.* (i) Under section 167*(l)*(3)(B), the term "pre-1970 public utility property" means property which was public utility property at any time before January 1, 1970. If a taxpayer acquires pre-1970 public utility property, such property shall be pre-1970 public utility property in the hands of the taxpayer even though such property may have been acquired by the taxpayer in an arm's length cash sale at fair market value or in a tax-free exchange. Thus, for example, if corporation X which is a member of the same controlled group of corporations (withing the meaning of section 1563(a)) as corporation Y sells pre-1970 public utility property to Y, such property is pre-1970 public utility property in the hands of Y. The result would be the same if X and Y were not members of the same controlled group of corporations.

(ii) If the basis of public utility property acquired by the taxpayer in a transaction is determined in whole or in part by

reference to the basis of any any of the taxpayer's pre-1970 public utility property by reason of the application of any provision of the Code, and if immediately after the transaction the adjusted basis of the property acquired is less than 200 percent of the adjusted basis of such pre-1970 public utility property immediately before the transaction, the property acquired is pre-1970 public utility property.

(2) *Methods of depreciation not prohibited.* Under section 167*(l)*(1), in the case of pre-1970 public utility property, the term "reasonable allowance" as used in section 167(a) means, for a taxable year for which a Federal income tax return was not filed before August 1, 1969, and in which such property is public utility property, an allowance (allowable without regard to section 167*(l)*) computed under—

(i) A subsection *(l)* method or

(ii) The applicable 1968 method (other than a subsection *(l)* method) used by the taxpayer for such property, but only if—

(a) The taxpayer uses in respect of such taxable year a normalization method of regulated accounting for such property,

(b) The taxpayer used a flow-through method of regulating accounting for such property for its July 1969 regulated accounting period, or

(c) The taxpayer's first regulated accounting period with respect to such property is after the taxpayer's July 1969 regulated accounting period and the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service. See paragraph (e)(5) of this section for determination of same (or similar) kind.

(3) *Flow-through method of regulated accounting in certain cases.* See paragraph (e)(6) of this section for treatment of certain taxpayers with pending applications for change in method of accounting as being deemed to have used a flow-

through method of regulated accounting for the July 1969 regulated accounting period.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation X, a calendar-year taxpayer subject to the jurisdiction of a regulatory body described in section 167*(l)*(3)(A), used the straight line method of depreciation (a subsection *(l)* method for all of its public utility property for which depreciation was allowable on its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return.) Assume that under paragraph (e) of this section, X's applicable 1968 method is a subsection *(l)* method with respect to all of its public utility property. Thus, with respect to its pre-1970 public utility property, X may only use a straight line method (or any other subsection *(l)* method) of depreciation for all taxable years after 1967.

Example (2). Corporation Y, a calendar-year taxpayer subject to the jurisdiction of the Federal Power Commission, is engaged exclusively in the transportation of gas by pipeline. On its Federal income tax return for 1967 (the latest taxable year for which Y, prior to August 1, 1969, filed a return), Y used the declining balance method of depreciation using a rate of 150 percent of the straight line rate for all of its non-section 1250 public utility property with respect to which depreciation was allowable. Assume that with respect to all such property, Y's applicable 1968 method under paragraph (e) of this section is such 150 percent declining balance method. Assume that Y used a normalization method of regulated accounting for all relevant regulated accounting period. If Y continues to use a normalization method of regulated accounting, Y may compute its reasonable allowance for purposes of section 167(a) using such 150 percent of declining balance method for its non-section 1250 pre-1970 public utility property for all taxable years beginning with 1968, provided that use of such method is allowable

without regard to section 167*(l)*. Y may also use a subsection *(l)* method for any of such pre-1970 public utility property for all taxable years beginning after 1967. However, because each different uniform rate applied to the basis of the property is a different method of depreciation, Y may not use a declining balance method of depreciation using a rate of twice the straight line rate for any of such pre-1970 public utility property for any taxable year beginning after 1967.

Example (3). Assume the same facts as in example (2) except that with respect to all of its non-section 1250 pre-1970 public utility property accounted for its July 1969 regulated accounting period Y used a flow-through method of regulated accounting for such period. Assume further that such property is the property on the basis of which the applicable 1968 method is established for pre-1970 public utility property of the same kind, but having a first regulated accounting period after the taxpayer's July 1969 regulated accounting period. Beginning with 1968, with respect to such property Y may compute its reasonable allowance for purposes of section 167(a) using the declining balance method of depreciation and a rate of 150 percent of the straight line rate, whether it uses a normalization or flow-through method of regulated accounting after its July 1969 regulated accounting period, provided the use of such method is allowable without regard to section 167*(l)*.

(d) *Post-1969 public utility property*—(1) *In general.* Under section 167*(l)*(3)(C), the term "post-1969 public utility property" means any public utility property which is not pre-1970 public utility property.

(2) *Methods of depreciation not prohibitied.* Under section 167*(l)*(2), in the case of post-1969 public utility property, the term "reasonable allowance" as used in section 167(a) means, for a taxable year, an allowance (allowable without regard to section 167*(l)* computed under—

(i) A subsection *(l)* method,

(ii) A method of depreciation otherwise allowable under section 167 if, with respect to the property, the taxpayer uses in respect of such taxable year a normalization method of regulated accounting, or

(iii) The taxpayer's applicable 1968 method (other than a subsection *(l)* method) with respect to the property in question, if the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for the property of the same (or similar) kind most recently placed in service, provided that the property in question is not property to which an election under section *(l)*(4)(A? applies. See § 1.167*(l)*-2 for rules with respect to an election under section 167*(l)*(4)(A). See paragraph (e)(5) of this section for definition of same (or similar) kind.

(3) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1): Corporate X is engaged exclusively in the trade or business of the transportation of gas by pipeline and is subject to the jurisdiction of the Federal Power Commission. With respect to all its public utility property, X's applicable 1968 method (as determined under paragraph (e) of this section) is the straight line method of depreciation. X may determine its reasonable allowance for depreciation under section 167(a) with respect to its post-1969 public utility property under a straight line method (or other subsection *(l)* method) or, if X uses a normalization method of regulated accounting, any other method of such other method is allowable under section 167 without regard to section 167*(l)*.

Example (2). Assume the same facts as in example (1) except that with respect to all of X's post-1969 public utility property the applicable 1968 method (as determined under paragraph (e) of this section) is the declining balance method using a rate of 150 percent of the straight line rate. Assume further that all of X's pre-1970 public utility property was accounted for in its July 1969 regulated accounting period, and that X used a flowthrough method of regulated accounting for such period. X may determine its reasonable allowance for depreciation under section 167 with respect to its post-1969 public utility property by using the straight line method of depreciation (or any other subsection *(l)* method), by using any method otherwise allowable under section 167 (such as a declining balance method) if X uses a normalization method of regulated accounting, or, by using the declining balance method using a rate of 150 percent of the straight line rate, whether or not X uses a normalization or a flow-through method of regulated accounting.

(e) *Applicable 1968 method*—(1) *In general.* Under section 167*(l)*(3)(D), except as provided in subparagraphs (3) and (4) of this paragraph, the term "applicable 1968 method" means with respect to any public utility property—

(i) The method of depreciation properly used by the taxpayer in its Federal income return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969.

(ii) If subdivision (i) of this subparagraph does not apply, the method of depreciation properly used by the taxpayer in its Federal income tax return for the latest taxable year for which a return was filed before August 1, 1969, with respect to public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service before the end of such latest taxable year, or

(iii) If neither subdivision (i) or (ii) of this subparagraph applies, a subsection *(l)* method. If, on or after August 1, 1969, the taxpayer files an amended return for the taxable year referred to in subdivision (i) and (ii) of this subparagraph, such amended return shall not be taken into consideration in determining the applicable 1968 method. The term "applicable 1968 method" also means with respect to any public

utility property, for the year of change and subsequent years, a method of depreciation otherwise allowable under section 167 to which the taxpayer changes from an applicable 1968 method if such new method results in a lesser allowance for depreciation for such property under section 167 in the year of change and the taxpayer secures the Commissioner's consent to the change in accordance with the procedures of section 446(e) and § 1.446-1.

(2) *Placed in service.* For purposes of this section, property is placed in service on the date of which the period for depreciation begins under section 167. See for example, § 1.167(a)-10(b) and § 167(a)-11(c)(2). If under an averaging convention property which is placed in service (as defined in § 1.46-3(d)(ii) by the taxpayer on different dates is treated as placed in service on the same date, then for purposes of section 167*(l)* the property shall be treated as having been placed in service on the date the period for depreciation with respect to such property would begin under section 167 absent such averaging convention. Thus, for example, if, except for the fact that the averaging convention used assumes that all additions and retirements made during the first half of the year were made on the first day of the year, the period of depreciation for two items of public utility property would begin on January 10 and March 15, respectively, then for purposes of determining the property of the same (or similar) kind most recently placed in service, such items of property shall be treated as placed in service on January 10 and March 15, respectively.

(3) *Certain section 1250 property.* If a taxpayer is required under section 167(j) to use a method of depreciation other than its applicable 1968 method with respect to any section 1250 property, the term "applicable 1968 method" means the method of depreciation allowable under section 167(j) which is the most nearly comparable method to the applicable 1968 method on new section 1250 property is the declining balance

method using 200 percent of the straight line rate, the most nearly comparable method allowable for new section 1250 property under section 167(j) would be the declining balance method using 150 percent of the straight line rate. If the applicable 1968 method determined under subparagraph (1) of this paragraph is the sum of the years-digits method the term "most nearly comparable method" refers to any method of depreciation allowable under section 167(j).

(4) *Applicable 1968 method in certain cases.* (i)(a) Under section 167*(l)*(3)(E), if the taxpayer evidenced within the time and manner specified in (b) of this subdivision (i) the intent to use a method of depreciation under section 167 (other than its applicable 1968 method as determined under subparagraph (1) or (3) of this paragraph or a subsection *(l)* method) with respect to any public utility property, such method of depreciation shall be deemed to be the taxpayer's applicable 1968 method with respect to such public utility property and public utility of the same (or most similar) kind subsequently placed in service.

(b) Under this subdivision (i), the intent to use a method of depreciation under section 167 is evidenced—

(1) By a timely application for permission for a change in method of accounting filed by the taxpayer before August 1, 1969, or

(2) By the use of such method of depreciation in the computation by the taxpayer of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 regulated accounting period, as established in the manner prescibed in subparagraph (g)(1)(i), (ii), or (iii) of this section.

(ii)(a) If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in

exchange) from a related person, then in the hands of the transferee the applicable 1968 method with respect to such property shall be determined by reference to the treatment in respect of such property in the hands of the transferor.

(b) For purposes of this subdivision (ii), the term "related person" means a person who is related to another person if either immediately before or after the transfer—

(1) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers) or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships) and the regulations thereunder, or

(2) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a) and the regulations thereunder.

(5) *Same or similar.* The classification of property as being of the same (or similar) kind shall be made by reference to the function of the public utility to which the primary use of the property relates. Property which performs the identical function in the identical manner shall be treated as property of the same kind. The determination that property is of a similar kind shall be made by reference to the proper account to which expenditures for the property are chargeable under the system of regulated accounts required to be used by the taxpayer for the period in which the property in question was acquired. Property, the expenditure for which is chargeable to the same account, is property of the most similar kind. Property, the expenditure for which is chargeable to an account for property which serves the same general function, is property of a similar kind. Thus, for example, if corporation X, a natural gas company, subject to the jurisdiction of the

Federal Power Commission, had property properly chargeable to account 366 (relating to transmission plant structures and improvements) acquired an additional structure properly chargeable to account 366, under the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective September 1, 1968, the addition would constitute property of the same kind if it performed the identical function in the identical manner. If, however, the additional did not perform the identical function in the identical manner, it would be property of the most similar kind.

(6) *Regulating method of accounting in certain cases.* Under section 167*(l)*(4)(B), if with respect to any pre-1970 public utility property the taxpayer filed a timely application for change in method of accounting referred to in subparagraph (4)(i)(b)(1) of this paragraph and with respect to property of the same (or similar) kind most recently placed in service the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period, then for purposes of section 167*(l)*(1)(B) and paragraph (c) of this section the taxpayer shall be deemed to have used a flow-through method of regulated accounting with respect to such pre-1970 public utility property.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation X is a calandar-year taxpayer. On its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return) X used a straight line method of depreciation with respect to certain public utility property placed in service before 1965 and used the declining balance method of depreciation using 200 percent of the straight line rate (double declining balance) with respect to the same kind of public utility property placed in service after 1964. In 1968 and 1970, X placed

in service additional public utility property of the same kind. The applicable 1968 method with respect to the above described public utility property as shown in the following chart:

Property held in 1970	Placed in service	Method on 1967 return	Applicable 1968 method
Group 1	Before 1965	Straight line	Straight line
Group 2	After 1964 and before 1968	Double declining balance	Double declining balance
Group 3	After 1967 and before 1969	.....	Double declining balance
Group 4	After 1968	.....	Double declining balance

Example (2). Corporation Y is a calendar-year taxpayer engaged exclusively in the trade or business of the furnishing of electrical energy. In 1954, Y placed in service hydroelectric generators and for all purposes Y has taken straight line depreciation with respect to such generators. In 1960, Y placed in service fossil fuel generators and for all purposes since 1960 has used the declining balance method of depreciation using a rate of 150 percent of the straight line rate (computed without reduction for salvage) with respect to such generators. After 1960 and before 1970, Y did not place in service any generators. In 1970, Y placed in service additional hydroelectric generators. The applicable 1968 method with respect to the hydroelectric generators placed in service in 1970 would be the straight line method because it was the method used by Y on its return for the latest taxable year for which Y filed a return before August 1, 1969, with respect to property of the same kind (i.e., hydroelectric generators) most recently placed in service.

Example (3). Assume the same facts as in example (2), except that the generators placed in service in 1970 were nuclear generators. The applicable 1968 method with respect to such generators is the declining balance method using a rate of 150 percent of the straight line rate because, with respect to property of the most similar kind (fossil fuel generators) most recently placed in service, Y used such declining balance method on its return for the latest taxable year for which it filed a return before August 1, 1969.

(f) *Subsection (l) method.* Under section 167*(l)*(3)(F), the term "subsection *(l)* method" means a reasonable and consistently applied ratable method of computing depreciation which is allowable under section 167(a), such as, for example, the straight line method or a unit of production method or machine hour method. The term "subsection *(l)* method" does not include any declining balance method (regardless of the uniform rate applied), sum of the years-digits method, or method of depreciation which is allowable solely by reason of section 167(b)(4) or (j)(1)(C).

(g) *July 1969 regulated accounting period*—(1) *In general.* Under section 167*(l)*(3)(I), the term "July 1969 regulated accounting period" means the taxpayer's latest accounting period ending before August 1, 1969, for which the taxpayer regularly computed, before January 1, 1970, its tax expense for purposes of reflecting operating results in its regulated books of account. The computation by the taxpayer of such tax expense may be established by reference of the following:

(i) The most recent periodic report of a period ending before August 1, 1969, required by a regulatory body described in section 167*(l)*(3)(A) having jurisdiction over the taxpayer's regulated books of account which was filed with such body before January 1, 1970 (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for a

period ending before August 1, 1969, but only if such report was distributed to the shareholders before January 1, 1970, and if the taxpayer's stocks or securities are traded in an established securities market during such period. For purposes of this subdivision, the term "established securities market" has the meaning assigned to such term in § 1.453-3(d)(4).

(iii) If subdivision (i) and (ii) of this subparagraph do not apply, entries made to the satisfaction of the district director before January 1, 1970, in its regulated books of account for its most recent accounting period ending before August 1, 1969.

(2) *July 1969 method of regulated accounting in certain acquisitions.* If public utility property is acquired in a transaction which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Codes, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the method of regulated accounting for such property's July 1969 regulated accounting period shall be determined by reference the treatment in respect of such property in the hands of the transferor. See paragraph (e)(4)(ii) of this section for definition of "related person".

(3) *Determination date.* For purposes of section 167*(l)*, any reference to a method of depreciation under section 167(a), or a method of regulated accounting, taken into account by the taxpayer in computing its tax expense for its July 1969 regulated accounting period shall be a reference to such tax expense as shown on the periodic report or report to shareholders to which subparagraph (1)(i) or (ii) of this paragraph applies or the entries made on the taxpayers regulated books of account to which subparagraph (1)(iii) of this paragraph applies. Thus, for example, assume that regulatory body A having jurisdiction over public utility property with respect to X's regulated books of account requires X to reflect its tax expense in such books using the same method of depreciation which regulatory body B uses for determing X's cost of service for ratemaking purposes. If in 1971, in the course of approving a rate change for X, B retroactively determines X's cost of service for ratemaking purposes for X's July 1969 regulated accounting period using a method of depreciation different from the method reflected in X's regulated books of account as of January 1, 1970, the method of depreciation used by X for its July 1969 regulated accounting period would be determined without reference to the method retroactively used by B in 1971.

(h) *Normalization method of accounting*—(1) *In general.* (i) Under section 167*(l)*, a taxpayer uses a normalization method of regulated accounting with respect to public utility property—

(a) If the same method of depreciation (whether or not a subsection *(l)* method) is used to compute both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(b) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in (a) of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

(ii) In the case of a taxpayer described in section 167*(l)(1)(B) or (2)(C)*, the reference in subdivision (i) of this subparagraph shall be a reference only to such taxpayer's "qualified public utility property". See § 1.167*(l)*-2(b) for definition of "qualified public utility property".

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than subsection *(l)* method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection *(l)* method, then the amount and time of the deferral of tax liability shall be taken and manner as is satisfactory to the district director.

(2) *Adjustments to reserve.* (i) The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account. The taxpayer need not establish a separate reserve account for such amount but the amount of deferred tax determined under subparagraph (1)(i) of this paragraph must be accounted for in such a manner so as to be readily identifiable. With respect to any account, the aggregate amount allocable to deferred tax under section 167*(l)* shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation under subparagraph (1)(i) of this paragraph. An additional exception is that the aggregate amount allocable to deferred tax under section 167*(l)* may be properly adjusted to reflect asset

retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Federal Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167*(l)*(2)(B) to use a method of depreciation other than a subsection *(l)* method if it uses a normalization method of regulated accounting. With respect to such property, X has not made any election under § 1.167(a)-11 (relating to depreciation based on class lives and asset depreciation based on class lives and asset depreciation ranges). In 1972, X places in service public utility property with an unadjusted basis of $2 million, and an estimated useful life of 20 years. X uses the declining balance method of depreciation with a rate twice the straight line rate. If X uses a normalization method of regulated accounting, the amount of depreciation allowable under section 167(a) with respect to such property for 1972 computed under the double declining balance method would be $200,000. X computes its tax expense and depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection *(l)* method). A depreciation allowance computed in this manner is $100,000. The excess of the depreciation allowance determined under the double declining blance method ($200,000) over the depreciation expense computered using the straight line method ($100,000) is $100,000. Thus assuming a tax rate of 48 percent, X used a normalization method of regulated accounting for 1972 with respect to property placed in service that year if for 1972 it added to a reserve $48,000 as taxes deferred as a result of the

use by X of a method of depreciation for Federal income tax purposes differed for that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account.

Example (2). Assume the same facts as in example (1), except that X elects to apply § 1.167(a)-11 with respect to all eligible property placed in service in 1972. Assume further that all property X placed in service in 1972 is eligible property. One hundred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.6 years. X uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years, and applies the half-year convention (described in § 1.167(a)-11(c)(2)(iii). In 1972, the depreciation allowable under section 167(a) with respect to property placed in service in 1972 is $114,285 (determined without regard to the normalization requirements in § 1.167(a)-11(b)(6) and in section 167*(l)*. X computes its tax expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection *(l)* method), an estimated useful life of 22 years (that is, 100 percent of the asset guideline period), and the half-year convention. A depreciation allowance computed in this manner is $45,454. Assuming a tax rate of 48 percent, the amount that X must add to a reserve for 1972 with respect to property placed in service that year in order to qualify as using a normalization method of regulated accounting under section 167*(l)*(3)(G) is $27,429 and the amount in order to satisfy the normalization requirements of § 1.167(a)-11(b)(6) is $5,610. X determined such amounts as follows:

(1) Depreciation allowance on tax return (determined without regard to section 167*(l)* and §1.167(a)-11(b)(6))	$114,285
(2) Line (1), recomputed using a straight line method	57,142

(3) Difference in depreciation allowance attributable to different methods (line (1) minus line (2))	$ 57,143
(4) Amount to add to reserve under this paragraph (48% of line (3))	$ 27,429
(5) Amount in line (2)	$ 57,142
(6) Line (5), recomputed by using an estimated useful life of 22 years and the half-year convention	$ 45,454
(7) Difference in depreciation allowance attributable to difference in depreciation periods	$ 11,688
(8) Amount to add to reserve under § 1.167(a)-11(b)(6)(ii) (48% of line (7))	$ 5,610

If, for its depreciation expense for purposes of determing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, X had used a period in excess of the asset guideline period of 22 years, the total amount in lines (4) and (8) in this example would not be changed.

Example (3). Corporation Y, a calendar-year taxpayer which is engaged in furnishing electrical energy, made the election provided by section 167*(l)*(4)(a) with respect to its "qualified public utility property" (as defined § 1.167*(l)*-2(b)). In 1971, Y placed in service qualified public utility property which had an adjusted basis of $2 million, estimated useful life of 20 years, and no salvage value. With respect to property of the same kind most recently placed in service, Y used a flow-through method of regulated accounting for its July 1969 regulated accounting period and the applicable 1968 method is the declining balance method of depreciation using 200 percent of the straight line rate. The amount of depreciation allowable under the double declining balance method with respect to the qualified public utility property would be $200,000. Y computes its tax expense and depreciation ex-

pense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation. A depreciation allowance with respect to the qualified public utility property determined in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus assuming a tax rate of 48 percent, Y used a normalization method of regulated accounting for 1971 if for 1971 it added to a reserve $48,000 as tax deferred as a result of the use by Y of a method of depreciation for Federal income tax purposes with respect to its qualified public utility property which method was different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account for such property.

Example (4). Corporation Z, exclusively engaged in a public utility activity did not use a flow-through method of regulated accounting for its July 1969 regulated accounting period. In 1971, a regulatory body having jurisdiction over all of Z's property issued an order applicable to all years beginning with 1968 which provided, in effect, that Z use an accelerated method of depreciation for purposes of section 167 and for determining its tax expenses for purposes reflecting operating results in its regulated books of account. The order further provided that Z normalize 50 percent of the tax deferral resulting from the use of the accelerated method of depreciation and that Z flow-through 50 percent of the tax deferral resulting therefrom. Under section 167*(l)*, the method of accounting provided in the order would not be a normalization method of regulated accounting because Z would not be permitted to normalize at 100 percent of the tax deferral resulting from the use of an accelerated method of depreciation. Thus, with respect to its public utility property

for purposes of section 167, Z may only use a subsection *(l)* method of depreciation.

Example (5). Assume the same facts as in example (4) except that the order of the regulatory body provided, in effect, that Z normalize 100 percent of the tax deferral with respect to 50 percent of its public utility property and flow-through the tax savings with respect to the other 50 percent of its property. Because the effect of such an order would allow Z to flow-through a portion of the tax savings resulting from the use of an accelerated method of depreciation, Z would not be using a normalization method of regulated accounting with respect to any of its properties. Thus, with respect to its public utilities property for purposes of section 167, Z may only use a subsection *(l)* method of depreciation.

(3) *Establishing compliance with normalization requirements in respect of operating books of account.* The taxpayer may establish compliance with the requirement in subparagraph (1)(i) of this paragraph in respect of reflecting operating results, and adjustments to a reserve, in its operating books of account by reference to the following:

(i) The most recent periodic report for a period beginning before the end of the taxable year, required by a regulatory body described in section 167*(l)*(3)(A) having jurisdiction over the taxpayer's regulated operating books of account which was filed with such body before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for such taxable year (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for the taxable year but only if *(a)* such report was distributed to the shareholders before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year and *(b)* the taxpayer's stocks and securities are traded in an established market during such taxable year.

For purposes of this subdivision, the term "established securities market" has the meaning assigned to such term in § 1.453-3(d)(4).

(iii) If neither subdivision (i) or (ii) of this subparagraph applies, entries made to the satisfaction of the district director before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year in its regulated books of account for its most recent period beginning before the end of such taxable year.

(4) *Establishing compliance with normalization requirements in computing cost of service for ratemaking purposes.* (i) In the case of a taxpayer which used a flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter, with respect to all or a portion of its pre-1970 public utility property, if a regulatory body having jurisidiction to establish the rates of such taxpayer as to such property (or a court which has jurisdiction over such body) issues an order of general application (or an order of specific application to the taxpayer) which states that such regulatory body (or court) will permit a class of taxpayers of which such taxpayer is a member (or such taxpayer) to use the normalization method of regulated accounting to establish cost of service for ratemaking purposes with respect to all or a portion of its public utility property, the taxpayer will be presumed to be using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to the public utility property to which such order applies. In the event that such order is in any way conditional, the preceding sentence shall not apply until all of the conditions contained in such order which are applicable to the taxpayer have been fulfilled. The taxpayer shall establish to the satisfaction of the Commissioner or his delegate that such conditions have been fulfilled.

(ii) In the case of a taxpayer which did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer which used a subsection *(l)* method of depreciation to compute its allowance for depreciation under section 167(a) and to compute its tax expense for purposes of reflecting operating results in its regulated books of account), with respect to any of its public utility property, it will be presumed that such taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public utility property. The presumption described in the preceding sentence shall not apply in any case where there is *(a)* an expression of intent (regardless of the manner in which such expression of intent is indicated) by the regulatory body (or bodies), having jurisdiction to establish the rates of such taxpayer, which indicates that the policy of such regulatory body is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or by a class of taxpayers of which such taxpayer is a member, or *(b)* a decision by a court having jurisdiction over such regulatory body which decision is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or a class of taxpayers of which such taxpayer is a member. The presumption shall be applicable on January 1, 1970, and shall, unless rebutted, be effective until an inconsistent expression of intent is indicated by such regulatory body or by such court. An example of such an inconsistent expression of intent is the case of a regulatory body which has, after the July 1969 regulated accounting period and before January 1, 1970, directed public utilities subject to its ratemaking jurisdiction to use a flow-through method of regulated accounting, or has issued an order of general application which states that such agency will direct a class of

public utilities of which the taxpayer is a member to use a flow-through method of regulated accounting. The presumption described in this subdivision may be rebutted by evidence that the flow-through method of regulated accounting. is being used by the taxpayer with respect to such property.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X is a calendar-year taxpayer and its "applicable 1968 method" is a straight line method of depreciation. Effective January 1, 1970, X began collecting rates which were based on a sum of the years-digits method of depreciation and a normalization method of regulated accounting which rates had been approved by a regulatory body having jurisdiction over X. On October 1, 1971, a court of proper jurisdiction annulled the rate order prospectively, which annulment was not appealed, on the basis that the regulatory body had abused its discretion by determining the rates on the basis of a normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X's use of the sum of the years-digits method of depreciation for purposes of section 167 on such return was proper. For 1971, the presumption is in effect through September 30. During 1971, X may use the sum of the years-digits method of depreciation for purposes of section 167 from January 1 through September 30, 1971. After September 30, 1971, and for taxable years after 1971, X must use a straight line method of depreciation until the inconsistent court decision is no longer in effect.

Example (2). Assume the same facts as in example (1), except that pursuant to the order of annulment, X was required to refund the portion of the rates attributable to the use of the normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X has the benefit of the

presumption with respect to its use of the sum of the years-digits method of depreciation for purposes of section 167, but because of the retroactive nature of the rate order X must file an amended return for 1970 using a straight line method of depreciation.

As the inconsistent decision by the court was handed down prior to the due date of X's Federal income tax return for 1971, for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. X must file its Federal income tax returns for such years using a straight line method of depreciation.

Example (3). Assume the same facts as in example (2), except that the annulment order was stayed pending appeal of the decision to a court of proper appellate jurisdiction. X has the benefit of the presumption as described in example (2) for the year 1970, but for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. Further, X must file an amended return for 1970 using a straight line method of depreciation and turns using a straight line method of of depreciation unless X and the district director have consented in writing to extend the time for assessment of tax for 1970 and thereafter with respect to the issue of normalization method of regulated accounting for as long as may be necessary to allow for resolution of the appeal with respect to the annulment of the rate order.

(5) *Change in method of regulated accounting.* The taxpayer shall notify the district director of a change in its method of regulated accounting, an order by a regulatory body or court that such method be changed, or an interim or final rate determination by a regulatory body which determination is inconsistent with the method of regulated accounting used by the taxpayer immediately prior to the effective date of such rate determination. Such notification shall be made within 90 days of the date that the change in method, the order, or the determination is effective. In the

case of a change in the method of regulated accounting, the taxpayer shall recompute its tax liability for any affected taxable year and such recomputation shall be made in the form of an amended return where necessary unless the taxpayer and the district director have consented in writing to extend the time for assessment of tax with respect to the issue of normalization method of regulated accounting.

(6) *Exclusion of normalization reserve from rate base.* (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167*(l)* which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking.

(ii) For the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of this subparagraph, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period. If solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period

and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period. The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period (or future portion).

(iii) The provisions of subdivision (i) of this subparagraph shall not apply in the case of a final determination of a rate case entered on or before May 31, 1973. For this purpose, a determination is final if all rights to request a review, a rehearing, or a redetermination by the regulatory body which makes such determination have been exhausted or have lapsed. The provisions of subdivision (ii) of this subparagraph shall not apply in the case of a rate case filed prior to June 7, 1974, for which a rate order is entered by a regulatory body having jurisdiction to establish the rates of the taxpayer prior to September 5, 1974 whether or not such order is final, appealable, or subject to further review or reconsideration.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Z Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167*(l)*(2)(B) to use a method of depreciation other than a subsection *(l)* method if it uses a normalization method of regulated accounting. With respect to X the Z Power Commission for purposes of establishing cost of service uses a recent consecutive 12-month period ending not more than 4 months prior to the

date of filing a rate case adjusted for certain known changes occurring within a 9-month period subsequent to the base period. X's rate case is filed on January 1, 1975. The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service. The rates are contemplated to be in effect for the years 1975, 1976, and 1977. The adjustments for known changes relate only to wages and salaries. X's rate base at the end of 1974 is $145,000,000. The amount of the reserve for deferred taxes under section 167*(l)* at the end of 1974 is $1,300,000, and the reserve is projected to be $4,400,000 at the end of 1975, $6,500,000 at the end of 1976, and $9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than $1,300,000 from the rate base to which X's rate of return is applied. Similarly, X does not use a normalization method of regulated accounting if, instead of the above, the Z Power Commission, in determining X's rate of return which is applied to the rate base, assigns to no-cost capital an amount that represents the reserve account for deferred tax that is greater than $1,300,000.

Example (2). Assume the same facts as in example (1) except that the adjustments for known changes in cost of service made by the Z Power Commission include an additional depreciation expense that reflects the installation of new equipment put into service on January 1, 1975. Assume further that the reserve for deferred taxes under section 167*(l)* at the end of 1974 is $1,300,000 and that the monthly net increases for the first 9 months of 1975 are projected to be

January	1-31	$ 310,000
February	1-28	300,000
March	1-31	300,000
April	1-30	280,000

May	1-31	270,000
June	1-30	260,000
July	1-31	260,000
August	1-31	250,000
September	1-30	240,000
		$2,470,000.

For its regulated books of account X accrues such increases as of the last day of the month but as a matter of convenience credits increases or charges decreases to the reserve account on the 15th day of the month following the whole month for which such increase or decrease is accrued. The maximum amount that may be excluded from the rate base is $2,470,879 (the amount in the reserve at the end of the historical portion of the period ($1,300,000) and a pro rata portion of the amount of any projected increase for the future portion of the period to be credited to the reserve ($1,170,879)). Such pro rata portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$310,000	X	243/273	=	$ 275,934
300,000	X	215/273	=	236,264
300,000	X	184/273	=	202,198
280,000	X	154/273	=	157,949
270,000	X	123/273	=	121,648
260,000	X	93/273	=	88,571
260,000	X	62/273	=	59,048
250,000	X	31/273	=	28,388
240,000	X	1/273	=	879
				$1,170,879

Example (3). Assume the same facts as in example (1) except that for purposes of establishing cost of service the Z Power Commission uses a future test year (1975). The rates are contemplated to be in effect for 1975, 1976, and 1977.

Assume further that plant additions, depreciation expenses, and taxes are projected to the end of 1975 and that the reserve for deferred taxes under section 167*(l)* is $1,300,000 for 1974 and is projected to be $4,400,000 at the end of 1975. Assume also that the Z Power Commission applies the rate of return to X's 1974 rate base of $145,000,000. X and the Z Power Commission through negotiation arrive at the level of approved rates. X uses a normalization method of regulated accounting only if the settlement agreement, the rate order, or record of the proceedings of the Z Power Commission indicates that the Z Power Commission did not exclude an amount representing the reserve for deferred taxes from X's rate base ($145,000,000) greater than $1,300,000 plus a pro rata portion of the projected increases and decreases that are to be credited or charged to the reserve account for 1975. Assume that for 1975 quarterly net increases are projected to be

1st quarter	$ 910,000
2nd quarter	810,000
3rd quarter	750,000
4th quarter	630,000
	$3,100,000

For its regulated books of account X will accrue such increases as of the last day of the quarter but as a mater of convenience will credit increases or charge decreases to the reserve account on the 15th day of the month following the last month of the quarter for which such increase or decrease will be accrued. The maximum amount that may be excluded from the rate base is $2,591,480 (the amount of the reserve at the beginning of the period ($1,300,000) plus a pro rata portion ($1,291,480) of the $3,100,000 projected increase to be credited to the reserve during the period). Such portion is

computed (without regard to the date such increase will actually be posted to the account) as follows:

$910,000	X	276/365	=	$ 688,110
810,000	X	185/365	=	410,548
750,000	X	93/365	=	191,096
630,000	X	1/365	=	1,726
				$1,291,480

(i) *Flow-through method of regulated accounting.* Under section 167*(l)*(3)(H), a taxpayer uses a flow-through method of regulated accounting with respect to public utility property if it uses the same method of depreciation (other than a subsection *(l)* method) to compute its allowance for depreciation under section 167 and to compute its tax expense for purposes of reflecting operating results in its regulated books of account unless such method is the same method used by the taxpayer to determine its depreciation expense for purposes of reflecting operating results in its regulated books of account. Except as provided in the preceding sentence, the method of depreciation used by a taxpayer with respect to public utility property for purposes of determining cost of service for ratemaking purposes or rate base for ratemaking purposes shall not be considered in determining whether the taxpayer used a flow-through method of regulated accounting. A taxpayer may establish use of a flow-through method of regulated accounting in the same manner that compliance with normalization requirements in respect of operating books of account may be established under paragraph (h)(4) of this section.

§ 1.167*(l)*-2 (Originally § 1.167*(l)*-4 as promulgated by T.D. 7045, filed 6-5-70; redesignated and amended by T.D. 7315, filed 6-6-74.) Public utility property; election as to post-1969 property presenting growth in capacity.

(a) *In general.* Section 167*(l)*(2) prescribes the methods of

depreciation which may be used by a taxpayer with respect to its post-1969 public utility property. Under section 167*(l)*(2)(A) and (B) the taxpayer may use a subsection *(l)* method of depreciation (as defined in section 167*(l)*(3)(F)) or any other method of depreciation which is otherwise allowable under section 167 if, in conjunction with the use of such other method such taxpayer uses the normalization method of accounting (as defined in section 167*(l)*(3)(G)). Paragraph (2)(C) of section 167*(l)* permits a taxpayer which used the flow-through method of accounting for its July 1969 accounting period (as these terms are defined in section 167*(l)*(3)(H) and (I), respectively) to use its applicable 1968 method of depreciation with respect to certain property. Section 167*(l)*(3)(D) describes the term "applicable 1968 method". Accordingly, a regulatory agency is not precluded by section 167*(l)* from requiring such a taxpayer subject to its jurisdiction to continue to use the flow-through method of accounting unless the taxpayer makes the election pursuant to section 167*(l)*(4)(A) and this section. Whether or not the election is made, if such regulatory agency permits the taxpayer to change from the flow-through method of accounting, subsection *(l)*(2)(A) or (B) would apply and such taxpayer could, subject to the provisions of section 167(e) and the regulations thereunder (relating to change in method), use a subsection *(l)* method of depreciation or, if the taxpayer uses the normalization method of accounting, any other method of depreciation otherwise allowable under section 167.

(1) *Election.* Under subparagraph (A) of section 167*(l)*(4), if the taxpayer so elects, the provisions of paragraph (2)(C) of section 167*(l)* shall not apply to its qualified public utility property (as such term is described in paragraph (b) of this section). In such case the taxpayer making the election shall use a method of depreciation prescribed by section 167*(l)*(2)(A) or (B) with respect to such property.

(2) *Property to which election shall apply.* (i) Except as provided in subdivision (ii) of this subparagraph the election provided by section 167*(l)*(4)(A) shall apply to all the qualified public utility property of the taxpayer.

(ii) In the event that the taxpayer wishes the election provided by section 167*(l)*(4)(A) to apply to only a portion of its qualified public utility property, it must clearly identify the property to be subject to the election in the statement of election described in paragraph (e) of this section. Where all property which performs a certain function is included within the election, the election shall apply to all future acquisitions of qualified public utility property which performs the same function. Where only certain property within a functional group of property is included within the election, the election shall apply only to property which is of the same kind as the included property.

(iii) The provisions of subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example (1). Corporation A, an electric utility company, wishes to have the election provided by section 167*(l)*(4)(A) apply only with respect to its production plant. A statement that the election shall apply only with respect to production plant will be sufficient to include within the election all of the taxpayer's qualified production plant of any kind. All public utility property of the taxpayer other than production plant will not be subject to the election.

Example (2). Corporation B, an electric utility company, wishes to have the election provided by section 167*(l)*(4)(A) apply only with respect to nuclear production plant. A statement which clearly indicates that only nuclear production plant will be included in the election will be sufficient to exclude from the election all public utility property other than nuclear production plant.

(b) *Qualified public utility property*—(1) *Definition.* For purposes of this section the term "qualified public utility

property" means post-1969 public utility property to which section 167(*l*)(2)(C) applies, or would apply if the election described in section 167(*l*)(4)(A) had not been made, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in section 167(*l*)(3)(A) and does not represent the replacement of existing capacity. In the event that particular assets which are post-1969 public utility property both replace existing public utility property and increase the productive or operational capacity of the taxpayer, only that portion of each such asset which is properly allocable, pursuant to the provisions of subparagraph (3)(v) of this paragraph or paragraph (c)(2) of this section (as the case may be), to increasing the productive or operational capacity of the taxpayer shall be qualified public utility property.

(2) *Limitation on use of formula method.* A taxpayer which makes the election with respect to all of its post-1969 public utility property may determine the amount of its qualified public utility property by using the formula method described in paragraph (c) of this section or, where the taxpayer so chooses, it may use any other method based on engineering data which is satisfactory to the Commissioner. A taxpayer which chooses to include only a portion of its post-1969 public utility property in the election described in paragraph (a)(1) of this section shall, in a manner satisfactory to the Commissioner and consistent with the provisions of subparagraph (3) of this paragraph, use a method based on engineering data. If a taxpayer uses the formula method described in paragraph (c) of this section, it must continue to use such method with respect to additions made in subsequent taxable years. The taxpayer may change from an engineering method to the formula method described in paragraph (c) of this section by filing a statement described in paragraph (h) of this section if it

could have used such formula method for the prior taxable year.

(3) *Measuring capacity under an engineering method in the case of a general election.* (i) The provisions of this subparagraph apply in the case of an election made with respect to all of the post-1969 public utility property of the taxpayer.

(ii) A taxpayer which uses a method based on engineering data to determine the portion of its additions for a taxable year which constitutes qualified public utility property shall make such determination with reference to its "adjusted capacity" as of the first day of the taxable year during which such additions are placed in service. For purposes of this subparagraph, the term "adjusted capacity" means the taxpayer's capacity as of January 1, 1970, adjusted upward in the manner described in subdivision (iii) of this subparagraph for each taxable year ending after December 31, 1969, and before the first day of the taxable year during which the additions described in the preceding sentence are placed in service.

(iii) The adjustment described in this subdivision for each taxable year shall be equal to the number of units of capacity by which additions for the taxable year of public utility property with respect to which the election had been made exceed the number of units of capacity of retirements for such taxable year of public utility property with respect to which the flow-through method of accounting was being used at the time of their retirement. If for any taxable year the computation in the preceding sentence results in a negative amount,such negative amount shall be taken into account as a reduction in the amount of the adjustment (computed without regard to this sentence) in succeeding taxable years.

(iv) The provisions of this subparagraph may be illustrated by the following table which assumes that the taxpayer's adjusted capacity as of January 1, 1970, was 5,000 units:

1	2	3	4	5	6	7
Year	*Additions*	*Flow-through Retirements*	*Net Additions*	*Adjusted Capacity*[1]	*Actual Capacity*	*Units of Qualified Additions*[2]
1970	1000	700	300	5000	5300	300
1971	300	500	(200)	5300	5100	–
1972	500	200	300	5300	5400	100
1973	400	800	(400)	5400	5000	–
1974	600	400	200	5400	5200	–
1975	2800	300	500	5400	5700	300

[1]Capacity as of January 1, 1970 plus amounts in column 7 for years prior to the year for which determination is being made.
[2]Column 6 minus column 5.

(v) The qualified portion of the basis for depreciation (as defined in section 167 (g)) of each asset or group of assets (if group or composite accounting is used by the taxpayer) subject to the election shall be determined using the following ratio:

$$\frac{\text{Qualified portion of basis of asset}}{\text{Total basis of asset}} = \frac{\text{Units of qualified additions computed in column 7 on chart}}{\text{Units of capacity of additions computed in column 2 on chart}}$$

(c) *Formula method of determining amount of property subject to election*—(1) *In general.* The following formula method may be used to determine the amount of qualified public utility property:

Step 1. Find the total cost (within the meaning of section 1012) to the taxpayer of additions during the taxable year of all post-1969 public utility property with respect to which section 167*(l)*(2)(C) would apply if the election had not been made.

Step 2. Aggregate the cost (within the meaning of section 1012) to the taxpayer of all retirements during the taxable year of public utility property with respect to which the flow-through method of accounting was being used at the time of their retirement.

Step 3. Subtract the figure reached in step 2 from the figure reached in step 1.

In the event that the figure reached in step 2 exceeds the figure reached in step 1 such excess shall be carried forward to the next taxable year and shall be aggregate with the cost (within the meaning of section 1012) to the taxpayer of all retirements referred to in step 2 for such next taxable year.

(2) *Allocation of bases.* The amount of qualified public utility property as determined in accordance with the formula method described in subparagraph (1) of this paragraph shall be allocated to the basis for depreciation (as defined in section 167(g)) of each asset or group of assets (if group or composite accounting is used by the taxpayer) subject to the election using the following ratio:

$$\frac{\text{Amount of qualified additions computed in step 3}}{\text{Amount of total additions computed in step 1}} = \frac{\text{Qualified portion of basis of asset}}{\text{Total basis of asset}}$$

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Corporation A, a telephone company subject to the jurisdiction of the Federal Communications Commission, elected, pursuant to the provisions of section 167*(l)*(4)(A) and this section, with respect to all of its qualified post-1969 public utility property to have the provisions of paragraph (2)(C) of section 167*(l)* not apply. In 1971 the Corporation added new underground cable with a cost (within the meaning of section 1012) to it of $4.0 million to its underground cable account. In the same year it retired public utility property with a cost (within the meaning of section 1012) to Corporation A of $1.5 million. The flow-through method of accounting was being used with respect to all of the retired property at the time of retirement. Using the for-

mula method described in paragraph (c) of this section, the amount of qualified underground cable would be determined as follows:

Step 1. Aggregate cost of flow-through additions $4.0 million
Step 2. Cost of all flow-through retirements.... $1.5 million
Step 3. Figure reached in step 1 less figure reached in step 2..... $2.5 million

The amount of qualified public utility property to which section 167*(l)*(2)(C) will not apply is $2.5 million. Pursuant to the provisions of paragraph (c)(2) of this section, the amount of qualified public utility property would be allocated to the basis for depreciation (as defined in section 167(g)) of an asset with a total basis for depreciation of $2 million as follows:

$$\frac{\text{\$2.5 million (figure in step 3)}}{\text{\$4 million (figure in step 1)}} = \frac{\text{Qualified portion of basis of asset}}{\text{\$2 million}}$$

Qualified portion of basis of asset = $1.25 million

Example (2). In 1972 Corporation A (the corporation described in example (1)) added underground cable with a cost (within the meaning of section 1012) to it of $1.0 million. In the same year the cost (within the meaning of section 1012) to the corporation of retirements of public utility property with respect to which the flow-through method of accounting was being used was $3.0 million. There were no other additions or retirements. The amount of qualified public utility property would be determined as follows:
Step 1. Aggregate cost of flow-through additions $1.0 million
Step 2. Cost of all flow-through retirements.... $3.0 million

Step 3. Figure reached in step 1 less figure reached in step 2.....(2.0 million)
Since retirements of flow-through public utility property for the year 1972 exceeded additions made during such year, the excess retirements, $2.0 million, must be carried forward to be aggregated with retirements for 1973.

Example (3). Corporation B, a gas pipeline company subject to the jurisdiction of the Federal Power Commission, made the election provided by section 167*(l)*(4)(A) and this section with respect to all of its post-1969 public utility property. Corporation B chose to use an engineering data method of determining which property was subject to the election provided by this section. In 1970, the corporation replaced a portion of its pipeline with respect to which the flow-through method of accounting was being used at the time of its retirement which had a peak capacity on January 1, 1970, of 100,000 thousand cubic feet (MCF) per day at a pressure of 14.73 pounds per square inch absolute (PSIA) with pipe with a capacity of 125,000 MCF per day at 14.73 PSIA. Assuming that there were no other additions or retirements, using an engineering data method one-fifth of the new pipeline would be property subject to the election of this section effective for its taxable year beginning on January 1, 1971.

Example (4). In 1970 Corporation C (with the same characteristics as the corporation described in example (3)) extended its pipeline five miles further than it extended on January 1, 1970. Assuming that there were no other additions or retirements, the entire extension would be property subject to the election provided by this section effective for its taxable year beginning on January 1, 1971.

Example (5). As a result of a change of service areas between two corporations, in 1970 Corporation D (with the same characteristics as the corporation described in example (3))retired a pipeline running north and south and replaced it with a pipeline of equal length and capacity running east and

west. No part of the pipeline running east and west is properly subject to the election.

(e) *Manner of making election.* The election described in paragraph (a) of this section shall be made by filing, in duplicate, with the Commissioner of Internal Revenue, Washington D.C. 20224, Attention T:I:E, a statement of such election.

(f) *Content of statement.* The statement described in paragraph (e) of this section shall indicate that an election is being made under section 167*(l)* of the Internal Revenue Code of 1954, and it shall contain the following information:

(1) The name, address, and taxpayer identification number of the taxpayer.

(2) Whether the taxpayer will use the formula method of determining the amount if its qualified public utility property described in paragraph (c) of this section, or an engineering method, and

(3) Where the taxpayer wishes to include only a portion of its public utility property in the election pursuant to the provisions of paragraph (a)(2) of this section, a description sufficient to clearly identify the property to be included.

(g) *Time for making election.* The election permitted by this section shall be made by filing the statement described in paragraph (e) of this section not later than Monday, June 29, 1970.

(h) *Change of method of determining amount of qualified property.* Where a taxpayer which has elected pursuant to the provisions of section 167*(l)*(4)(A) wishes to change, pursuant to the provisions of paragraph (b)(2) of this section, from an engineering data method of determining which of its property is qualified public utility property to the formula method described in paragraph (c) of this section, it may do so by filing a statement to that effect at the time that it files its income tax return, with the district director or director of the

regional service center, with whom the taxpayer's income tax return is required to be filed.

(i) *Revocability of election.* An election made under section 167*(l)* shall be irrevocable.

(j) *Effective date.* The election prescribed by section 167*(l)*(4)(A) and this section shall be effective for taxable years beginning after December 31, 1970.

§ 1.167*(l)*-3 (T.D. 7315, filed 6-6-74.) Multiple regulation, asset acquisitions, reorganizations, etc.

(a) *Property not entirely subject to jurisdiction of one regulatory body*—(1) *In general.* If a taxpayer which uses a method of depreciation other than a subsection *(l)* method of depreciation is required by a regulatory body having jurisdiction over less than all of its property to use, or not to use, a method of regulated accounting (i.e., normalization or flow-through), such taxpayer shall be considered as using, or not using, such method of regulated accounting only with respect to property subject to the jurisdiction of such regulatory body.

In the case of property which is contained in a multiple asset account, the provisions of § 1.167(a)-7(c) and § 1.167(a)-11(c)(1)(iv) apply to prohibit depreciating a single account by two or more different methods.

(2) *Jurisdiction of regulatory body.* For purposes of this paragraph, a regulatory body is considered to have jurisdiction over property of a taxpayer if expenses with respect to the property are included in cost of service as determined by the regulatory body for ratemaking purposes or for reflecting operating results in its regulated books of account. For example, if regulatory body A, having jurisdiction over 60 percent of an item of X corporation's public utility property, required X to use the flow-through method of regulated accounting in circumstances which would bar X from using a method of depreciation under section 167(a) other than a subsection *(l)*

method, and if regulatory body B, having jurisdiction over the remaining 40 percent of such item of property, does not so require X to use the flow-through method of regulated accounting (or if the remaining 40 percent is not subject to the jurisdiction of any regulatory body), then with respect to 60 percent of the adjusted basis of the property X is prohibited from using a method of depreciation for purposes of section 167(a) other than a subsection *(l)* method. If in such example, A, having jurisdiction over 60 percent of X's public utility property, had jurisdiction over 100 percent of a particular generator, then with respect to the generator X would be prohibited from using a method of depreciation other than a subsection *(l)* method.

(3) *Public utility property subject to more than one regulatory body.* If a regulatory body having jurisdiction over public utility property with respect to the taxpayer's regulated books of account requires the taxpayer to reflect its tax expense in such books in the manner used by the regulatory body having jurisdiction over the public utility property for purposes of determining the taxpayer's cost of service for ratemaking purposes, the rules of subparagraphs (1) and (2) of this paragraph shall apply.

(b) *Leasing transactions*—(1) *Leased property.* Public utility property as defined in paragraph (b) of § 1.167*(l)*-1 includes property which is leased by a taxpayer where the leasing of such property is part of the lessor's section 167*(l)* public utility activity. Thus, such leased property qualifies as public utility property even though the predominant use of such property by the lessee is in other than a section 167*(l)* public utility activity. Further, leased property qualifies as public uility property under section 167*(l)* even though the leasing is not part of the lessor's public utility activity if the predominant use of such property by the lessee or any sub-lessee is in a section 167*(l)* public utility activity. However, the limitations of

section 167*(l)* apply to a taxpayer only if such taxpayer is subject to the jurisdiction of a regulatory body described in section 167*(l)*(3)(A). For example, if a financial institution purchases property which it then leases to a lessee which uses such property predominantly in a section 167*(l)* public utility activity, the property qualifies as public utility property. However, because the financial institution's rates for leasing the property are not subject to the jurisdiction of a regulatory body described in section 167*(l)*(3)(A), the provisions of section 167*(l)* do not apply to the depreciation deductions taken with respect to the property by the financial institution. For possible application of section 167*(l)* to the lessee, see subparagraph (2) of this paragraph.

(2) *Certain rental payments.* Under section 167*(l)*(5), if a taxpayer leases property which is public utility property and the regulatory body having jurisdiction over such property for purposes of determining the taxpayer's operating results in its regulated books of account or for ratemaking purposes allows only an amount of such lessee's expenses with respect to the lease which is less than the amount which the taxpayer deducts for purposes of its Federal income tax liability, then a portion of the difference between such amounts shall not be allowed as a deduction by the taxpayer for purposes of its Federal income tax liability in such manner and time as the Commissioner or his delegate may determine consistent with the principles of § 1.167*(l)*-1 and this section applicable as to when a method of depreciation other than a subsection *(l)* method may be used for purposes of section 167(a).

(c) *Certain partnership arrangements.* See § 1.167 *(l)*-1(c)(1) for treatment of certain property held by a partnership is not public utility property in the hands of the partnership but would be public utility property if an election was made under section 761 to be excluded from partnership treatment, then section 167*(l)* shall be applied by treating the

partners as directly owning the property in proportion to their partnership interests.

(d) *Cross references.* See § 1.167*(l)*-1(c)(1) for treatment of certain property as "pre-1970 public utility property" and § 1.167*(l)*-1(e)(4)(ii) for applicable 1968 method in the case of property acquired in certain transactions.

§ 1.167*(l)*-4 (Originally § 1.167(e)-5 promulgated by T.D. 7128, filed 6-22-71; redesignated and amended by T.D. 7315, filed 6-6-74.) Public utility property; election to use asset depreciation range system.

(a) *Application of section 167(l) to certain property subject to asset depreciation range system.* If the taxpayer elects to compute depreciation under the asset depreciation range system described in § 1.167(a)-11 with respect to certain public utility property placed in service after December 31, 1970, see § 1.167(a)-11(b)(6).

Appendix D.

Me. Rev. Stat. tit. 35, § 51

§ 51 Safe facilities; just and reasonable rates

Every public utility is required to furnish safe, reasonable and adequate facilities. The rate, toll or charge, or any joint rate made, exacted, demanded or collected by any public utility for the conveyance or transportation of persons or property between points within this State, or for any heat, light, water or power produced, transmitted, delivered, or furnished, or for any telephone or telegraph message conveyed, or for any service rendered or to be rendered in connection with any public utility, shall be just and reasonable. In determining just and reasonable rates, the commission shall provide such revenues to the utility as may be required to perform its public service and to attract necessary capital on just and reasonable terms. Every unjust or unreasonable charge for such service is prohibited and declared unlawful. In determining just and reasonable rates, the commission may consider whether the utility is operating as efficiently as possible and is utilizing sound management practices.

R.S.1954, c.44 § 17; 1957, c.400, § 1; 1975, c.409

Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

NO. 79-725

THE STATE OF MAINE PUBLIC UTILITIES COMMISSION,
Petitioner,
v.
CENTRAL MAINE POWER COMPANY,
Respondent.

On Petition For A Writ of Certiorari To the Supreme Judicial Court of the State of Maine

BRIEF FOR RESPONDENT IN OPPOSITION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

NO. 79-725

THE STATE OF MAINE PUBLIC UTILITIES COMMISSION,
Petitioner,
v.
CENTRAL MAINE POWER COMPANY,
Respondent.

On Petition For A Writ of Certiorari
To the Supreme Judicial Court
of the State of Maine

BRIEF FOR RESPONDENT IN OPPOSITION

OPINIONS BELOW

The Opinion of the Maine Supreme Judicial Court (Appendix A to Petition) is now reported at 405 A.2d 153 (Me. 1979). The Decree of the Maine Public Utilities Commission (Appendix B to Petition) is reported in 26 P.U.R. 4th 388 (Me. P.U.C. 1978).

JURISDICTION

The Petition filed by the Maine Public Utilities Commission seeks to invoke this Court's jurisdiction under 28 U.S.C. § 1257(3). This Court lacks jurisdiction because no substantial federal question was decided in the state proceedings.

QUESTIONS PRESENTED BY THE PETITION

The Petition of the Maine Public Utilities Commission seeks to present the following issues to this Court:

> 1. Whether the Maine Public Utilities Commission's adjustment of a public utility's book depreciation expense to account for plant financed by its deferred tax reserve is inconsistent with the normalization requirements of §167(*l*).
>
> 2. Whether §167(*l*) of the Internal Revenue Code, which prescribes a normalization method of accounting to be used by a public utility that uses accelerated depreciation, requires that a state regulatory agency's treatment of depreciation for rate making purposes be consistent with that method of accounting. (Petition p.2)

STATUTES AND REGULATIONS INVOLVED

The applicable provision of the Maine public utility law (Me. Rev. Stat., title 35, § 51) is set forth as Appendix D to the Petition. The provisions of the Internal Revenue Code cited by the Petition (26 U.S.C. § 167(*l*)) and Treasury Regulations thereunder (26 C.F.R. § 1.167(*l*)) are set forth as Appendix C to the Petition.

STATEMENT OF THE CASE

Rate Case. This rate proceeding began before the Maine Public Utilities Commission (the "Commission"). Central Maine Power Company ("Central Maine") on

January 16, 1978, filed with the Commission a revised schedule of rates pursuant to Me. Rev. Stat., title 35, § 64. The Commission suspended the revised schedule under Me. Rev. Stat., title 35, § 69 in order to investigate the propriety of the proposed rates under applicable provisions of the Maine public utility law, Me. Rev. Stat., title 35. At issue were Central Maine's rates and charges for electric service within the State of Maine.

***New England* Decision.** While the Central Maine rate case was pending before the Commission, the Maine Supreme Judicial Court (the "Maine Court") decided *New England Tel. & Tel. Co. v. Pub. Util. Com'n,* 390 A.2d 8 (Me. 1978) (the "*New England*" case). The *New England* case held that the Commission had erred in refusing to use a normalization method of accounting in determining just and reasonable rates for New England Telephone. The Maine Court ruled that the Commission's refusal to normalize constituted "an unreasonable exercise of power and an abuse of discretion" under Maine law (1) because the adjustment arbitrarily disregarded the normalization method of accounting (which the Commission had ordered New England Telephone to follow), and (2) because the refusal to normalize arbitrarily "placed New England in jeopardy of losing its ability to take accelerated depreciation [for federal income tax purposes]." (390 A.2d at 24) The Maine Court stated:

> In view of our decision that the Commission's actions were arbitrary with regard to the treatment of the accelerated depreciation issue it becomes *unnecessary for us to decide whether under the Internal Revenue Code, New England would lose its right to take accelerated depreciation* if the Commission persisted in imputing flow-through of the taxes deferred. Even though all indications, including the language of the Code and the stated purposes of §167(*l*), strongly

> suggest that result would obtain, it is unnecessary for us in this case to so declare. (*Ibid.; cf.* Appendix to Petition, p. 36)(Emphasis added)

The Maine Public Utilities Commission did not seek review by this court of the *New England* decision.

Section 167(*l*). Section 167(*l*) of the Internal Revenue Code was added by the Tax Reform Act of 1969 (P.L. 91-172). Under Section 167(*l*), a public utility may use accelerated depreciation for federal income tax purposes *only if* it uses a normalization method of accounting. (I.R.C. § 167(*l*)(2))

Normalization. Under the normalization method of accounting, a public utility (like Central Maine) that elects to use accelerated depreciation for federal income tax purposes, but computes depreciation expense for book purposes on the straight-line method, must for ratemaking purposes, have its depreciation expense and resulting tax expense determined on the straight-line method. (I.R.C. §167(*l*)(3)(G)) The difference between the tax computed by the straight-line method and the tax paid on the basis of accelerated depreciation in the early years of an asset's life—that is, the amount of deferred taxes—is set aside in a deferred tax reserve. (I.R.C. §167(*l*)(3)(G)(ii)) That reserve makes available to the public utility interest-free funds for plant expansion, service improvement, or other public utility purposes and to that extent reduces the utility's requirements for capital from external sources.

"Flow-Through." The term "flow-through" refers to any reduction in a public utility's federal income tax expense for ratemaking purposes (and thus the utility's rates) effectuated by computing that utility's federal income tax not on the basis of straight-line depreciation, but rather on the basis of accelerated depreciation. (Appendix to Petition, pp. 35-36) The benefits of accelerated depreciation

are thereby flowed through to utility ratepayers, rendering nugatory the Congressional purpose in providing the utility with the equivalent of an interest-free loan. Flow-through contravenes the normalization requirement of Section 167(*l*) and thus exposes the affected public utility to the risk of losing its eligibility to take accelerated depreciation.

Response to New England Decision. On the first day of hearings after the *New England* case was decided (July 10, 1978), the Commission Staff (acting as an advocate against Central Maine) abandoned its position in this proceeding which had argued for full flow-through and announced that it would propose an alternate adjustment. (Appendix to Petition, p. 37)

Commission counsel stated his reaction to the *New England* decision as follows:

> Now in light of the Supreme Court ruling in the Telephone Company case with reference to deferred federal income taxes and flowing through the benefits of the same, we may very well take the position that deferred federal income taxes are customer contributed capital and, therefore, recommend disallowing depreciation expense thereon. (Appendix to Petition, p. 37) (Emphasis added)

Partial Flow-Through. The Commission Staff, true to the advance warning of its counsel, ultimately proposed that the Commission effect a partial flow-through of Central Maine's deferred tax expense by disallowing as a ratemaking expense depreciation taken on that portion plant that was financed by deferred taxes. (Appendix to Petition, pp. 37-38) The Commission adopted the adjustment and reduced Central Maine's intrastate earnings for ratemaking purposes by some $641,500. (Appendix to Petition, p. 38, n. 23)

Rejection of Partial Flow-Through. The Maine Supreme Judicial Court recognized that the adjustment made by the Commission effected a partial flow-through of deferred taxes. On the authority of the *New England* case, the Maine Court found that the adjustment placed Central Maine in jeopardy of losing its eligibility to take accelerated depreciation for federal income tax purposes. (Appendix to Petition, pp. 42, 45, 56) The Maine Court held that the Commission's partial flow-through adjustment, ". . .would place Central Maine Power in jeopardy of losing its right to take accelerated depreciation for federal tax purposes and therefore constitute '*an arbitrary exercise of the Commission's power and. . .an abuse of its discretion*' prohibited by state law. *New England Telephone, supra,* at 23." (Appendix to Petition, p. 42; 405 A.2d at 168) (Emphasis in original)

The Maine Court first analyzed the effect of the Commission's adjustment on Central Maine's eligibility to take accelerated depreciation. The Court then stated the issue before it as follows:

> The issue is thus squarely presented: does the Commission adjustment place Central Maine *in jeopardy of losing* its right to take accelerated depreciation by departing from the requirements of normalization? (Appendix to Petition, p. 45) (Emphasis added)

The Maine Court carefuly phrased the issue in terms of "jeopardy of losing" the right to take accelerated depreciation. The court did not say the issue is: Will Central Maine in fact lose its right to take accelerated depreciation? Rather the court deliberately asked: does the adjustment place Central Maine *in jeopardy*? On its finding that the Commission's adjustment placed Central Maine in jeopardy, the Maine Court held that the Commission's actions constituted an abuse of discretion *under Maine public utility law; the Maine Court did not decide whether Central Maine Power Company would lose its right to take accelerated depreciation under the federal tax laws.* (Appendix to Petition, p. 56)

ARGUMENT

I. The Court Does Not Have Jurisdiction To Entertain The Petition.

A. No substantial federal question was decided.

The Maine Court did not decide any substantial question of federal law in this case. Rather, the Maine Court analyzed the specific ratemaking adjustment made by the Commission and applied its earlier decision that any ratemaking adjustment which places a public utility in jeopardy of losing its eligibility to take accelerated depreciation is arbitrary action and an abuse of discretion under state law. (Appendix to Petition, pp. 42, 45, 56)

The Maine Court held that the adjustment made by the Commission placed Central Maine *in jeopardy.* (Appendix to Petition, pp. 45, 56) That holding does not amount to a decision of federal law. Under the precedent established in the *New England* case, the Maine Court was not required to find that Central Maine would *absolutely and certainly* lose its eligibility to take accelerated depreciation if the Commission's partial flow-through were upheld. Rather, the Maine Court was required only to *assess the risk* created by the Commission's adjustment and decide whether that risk made the Commission's action an abuse of discretion under state law.

B. The Maine Court declined to certify that a federal question was decided.

Before filing its Petition with this Court, the Commission sought from the Maine Court a certificate that a fed-

eral question was decided in this case, and was necessary to the result reached. Specifically, the Commission by Motion (Appendix A to this Brief) asked the Maine Court to declare that:

> This Court sustained Central Maine Power Company's appeal. . .holding that the Commission's adjustment did violate the normalization requirements of I.R. C. § 167(*l*), and that this decision was necessary to the judgment rendered. (Appendix A hereto, p.2a)

The Maine Court by Order dated October 12, 1979 (Appendix B hereto, pp. 6a-8a), declined to issue any certificate.

In refusing to grant the requested certificate, the Maine Court observed that "[t]he Court's opinion speaks for itself, without need for clarification." (Appendix B hereto, p. 6a) The Maine Court quoted the following paragraph of its opinion (among others) as "the ground of decision":

> If the action here taken by the Commission constitutes a flow-through of deferred taxes, it would, of course, deplete the source of interest-free capital Congress sought to insure by enacting §167(*l*), and would thus be inconsistent with national economic policy. Simultaneously, it would place Central Maine Power in jeopardy of losing its right to take accelerated depreciation for federal tax purposes, and therefore constitute 'an arbitrary exercise of the Commission's power and. . .an abuse of its discretion' prohibited by state law. *New England Telephone, supra,* at 23. (Appendix B hereto, p. 7a) (Emphasis in original)

This Court has jurisdiction to review a state court decision by writ of certiorari only if (1) a substantial federal question was raised and decided in the state court proceeding, *and* (2) the decision was "a necessary ground for

reaching the judgment under review." *Herb v. Pitcairn,* 324 U.S. 117 at 128 (1945). This Court has stated:

> It is our purpose scrupulously to observe the long-standing rule that we will not review a judgment of a state court that rests on an adequate and independent ground in state law. (*Ibid*)

Here, the Maine Court's decision was grounded in state law. The Maine Court found that the Commission's partial flow-through constituted an arbitrary exercise of power and an abuse of discretion *under state law.* The Maine Court's conclusion that the adjustment placed Central Maine in jeopardy of losing its eligibility to take accelerated depreciation was subordinate to that state law determination.

C. Any federal question was insubstantial and not a necessary ground for the Maine Court's decision.

Any federal question incidentally considered by the Maine Court was insubstantial. The Maine Court did not consider the broader question whether full flow-through exposed a public utility to a risk of losing the right to take accelerated tax depreciation. The Maine Court had decided that issue in the *New England* case.

Neither did the Maine Court decide the federal question specifically reserved in the *New England* case: whether flow-through (full in the *New England* case, partial in the instant case) would result under the Internal Revenue Code in a loss of the utility's right to take accelerated depreciation.

The issue "squarely presented" below and determined by the Maine Court was: "does the Commission adjustment place Central Maine in jeopardy of losing its right to take accelerated depreciation . . ." (Appendix to Petition, p. 45). In assessing that jeopardy or risk the

Maine Court did indicate substantial agreement with the position taken by Central Maine Power Company that regulatory commission imposed accounting methods could result in adverse tax consequences to the utility under the Internal Revenue Code, (Appendix to Petition, pp. 48-49).

The Maine Court's assessment of the position of the parties on this "federal issue" was made, however, in the context of deciding a question of state law in both the *New England* case (390 A.2d at 23) and in the present case (Appendix to Petition, p. 42): would the Commission adjustment place Central Maine Power (or New England Telephone) in jeopardy of losing its right to take accelerated depreciation and therefore constitute an arbitrary exercise of Commission power and an abuse of discretion *prohibited by state law.*

Although the Maine Court in this case did not expressly reserve decision on the question whether regulatory imposed accounting standards will produce adverse tax consequences to the affected utility (as it did in the *New England* case), any view expressed concerning that "federal question" was unnecessary to the result reached. As was made clear in the *New England* case, the Maine Court would have reached the same result even if it had expressly reserved decision on the federal issue. Since the Commission adjustment had created the risk of adverse tax consequences, the Court concluded that the Commission erred as a matter of state law. Whether or not the Court reserved decision with respect to questions of federal law or expressed views on them was extraneous to the decision reached and therefore such questions were insubstantial.

In December of 1978, this Court denied *certiorari* in two companion cases seeking review of the question whether flow-through contravenes Section 167(*l*). *Pacific Tel. & Tel. Co. v. Pub. Util. Com'n*, 440 U.S. 931, 58 L.Ed.2d 713 (1978); *General Tel. Co. v. Pub. Util. Com'n,* 440 U.S. 931, 58 L.Ed.2d 713 (1978). The telephone utilities in those cases had filed petitions for review with the California Supreme Court seeking review of Decision No. 87838 of the California Public Utilities Commission entered on September 13, 1977. The California Supreme Court, without opinion, had denied the utilities' petitions for review on July 13, 1978, thereby upholding a decision of the California Public Utilities Commission requiring flow-through for rate making purposes.

The Maine Court did consider whether the specific adjustment made by the Commission, namely, the disallowance of depreciation on plant financed by deferred federal income taxes, was inconsistent with the normalization requirements of Section 167(*l*). The question was whether the specific adjustment made by the Commission, one of many that the ingenuity of regulatory commissions might invent to evade the purpose of Section 167(*l*), constituted a partial flow-through. The Maine Court found that the adjustment did constitute a partial flow-through and concluded that the Commission abused its discretion as a matter of state law in making the adjustment.

This case was decided on a state law ground, namely, that the Commission abused its discretion in making an adjustment having the potential of placing Central Maine in jeopardy of losing the right to take accelerated depreciation. The question whether the specific adjustment made in this case did constitute a partial flow-through under Section 167(*l*) was considered incidentally to the Maine Court's determination of a state law issue; that question is, however, insubstantial.

II. The Maine Court Was Correct.

A. The Commission adjustment constituted a partial flow-through of deferred federal taxes.

The Petition (pp. 9-10) argues that the disallowance of depreciation on plant financed by deferred taxes did not constitute a flow-through of those deferred taxes. The Maine Court stated:

> Full normalization requires that the *entire* deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account (namely, straight-line), and (b) the accelerated depreciation method used on the income tax return, be normalized. The methodology employed by the Commission results, instead, in a partial flow-through of those deferred taxes. That this end is accomplished not directly but by excluding from book depreciation a portion of the value of depreciable assets allowed for tax purposes under the rubric of a "*basis*" change is irrelevant. In either case normalization (and Congressional intent) is frustrated. In either case the amount of deferred taxes properly includible in the cost of service is reduced to the benefit of the ratepayers and to the detriment of the utility and national economic policy. (App., pp. 49-50) (Emphasis in original)

Examples 4 and 5 to I.R.S. Reg. § 1.167(*l*)—1(h)(2)(ii) emphasize that a public utility will not be deemed to use a normalization method of accounting if the *effect* of a *regulatory order* is to flow through a portion of the tax deferrals resulting from accelerated depreciation. Example 5 establishes that a flow-through of tax savings with respect to a certain proportion or percentage of a public utility's property, even though complete normalization is followed with respect to the remaining proportion, would not constitute a normalization method of accounting with respect

to *any* public utility property. A regulatory order requiring that method of accounting would result in the loss of the public utility's eligibility to take accelerated depreciation on *all* its public utility property, including that portion on which it had followed a normalization method of accounting.

The Commission's adjustment does exactly what Examples 4 and 5 proscribe; tax deferrals resulting from accelerated depreciation on a certain proportion of utility plant (*i.e.*, that proportion financed by deferred taxes) are flowed through to rate payers.

The Maine Court correctly ruled that the Commission's adjustment constituted a partial flow-through of the tax deferrals arising from accelerated depreciation. That partial flow-through exposed Central Maine to a risk of losing its eligibility to take accelerated depreciation and was therefore held to be an arbitrary exercise of the Commission's power and an abuse of it discretion under state law.

B. Section 167(*l*) of the Internal Revenue Code governs regulatory action.

The Petition (pp. 12-14) contends that even if the partial flow-through made by the Commission contravenes the normalization requirements of Section 167(*l*), Central Maine's eligibility to take accelerated depreciation is not in jeopardy because Section 167(*l*) governs only the method of accounting used by the *taxpayer*.

The Maine Court rejected that argument:

> . . .regulatory commission imposed accounting methods which violate the Internal Revenue Code will penalize the subject utility, irrespective of its reluctance to adopt such methods. A contrary conclusion would ask us to believe that Congress intended the strictures of § 167(*l*) to be merely advisory; that if state regula-

> tory agencies wish to defy national economic policy they are free to do so. Moreover, even a cursory reading of the I.R.S. Regulations and Private Letter Rulings cited to us makes it clear that, even if imposed by a regulatory body, accounting methods which violate § 167(*l*) would produce adverse tax consequences for the affected utility, (App., p. 48-49) (footnote omitted)

Internal Revenue Service Private Letter Ruling 7836038, dated June 8, 1978 issued with respect to "Taxpayer-Pacific Telephone & Telegraph Co." (Appendix C hereto), indicated that the Internal Revenue Service would deny the use of accelerated depreciation to that utility because the regulatory commission had prescribed "a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes." (Appendix C hereto, pp. 26a-27a). See also Internal Revenue Service Private Letter Ruling 7836048, dated June 9, 1978 issued with respect to "Taxpayer-General Telephone Company of California" (Appendix D hereto); I.R.S. Reg. § 1.167(*l*)-1(h)(2)(ii), Examples 4 and 5 (Appendix C of Petition, pp. 224-225).

It would be preposterous to suppose that Congress intended to require a public utility to *file* its rate cases on the basis of normalization but to leave the state regulatory commissions free to *impose* final rates on the basis of flow-through. Petitioner cites absolutely no authority to support its position that the accomplishment of a partial flow-through by indirect means is consistent with Section 167(*l*).

III. This Case Poses No Important Question Of Federal Law.

This is a rate case to establish intrastate rates under state law. The Maine Court's decision applied ratemaking principles under state law in finding the adjustment made

by the Commission to be an arbitrary exercise of power and an abuse of discretion. The ultimate question in any state rate-making proceeding is the justness and reasonableness of rates under state law (but, of course, subject to federal and state constitutional limitations). The Maine Court's finding that the specific adjustment made by the Commission placed Central Maine in jeopardy of losing its eligibility to take accelerated depreciation was based on state law and was itself a subordinate decision to the overall question of justness and reasonableness.

This is not a tax case. It would be inappropriate and premature for this Court to construe Section 167(*l*) in the context of the unique adjustment made by the Commission in this state rate proceeding. Any view expressed by this Court on this question in the context of an intrastate rate case would be advisory in nature. Conflicting interpretations of the tax law are best resolved in litigation between the taxpayer and the Internal Revenue Service. In such a context this Court's opinion would not be advisory in nature.

The Petition (pp. 7-11) urges this Court to resolve the "confusion that presently surrounds 167(*l*)" and thereby to restore the "delicate balance between state and federal areas of control." (Petition, pp. 9, 10) The only basis given by the Petition for that plea is the alleged inability of state courts to "come to grips with difficult and highly technical federal legislation." (Petition, p. 9)

This Court has recently denied *certiorari in Pacific Tel. & Tel. Co. v. Pub. Util. Com'n, supra,* 440 U.S. 931, 58 L.Ed.2d 713 (1978); *General Tel. Co. v. Pub. Util. Com'n, supra,* 440 U.S. 931, 58 L.Ed.2d 713 (1978). Considerations which militate against attempting to decide a federal tax question in the context of a state rate proceeding (even if it were substantial, which in this case, it is not) are equally applicable here and *certiorari* should also be denied.

The Petition argues that a major issue concerning the scope of Section 167(*l*) is present in this case. On the contrary, the only issue before the Maine Court in this case remotely resembling a federal issue was whether the specific adjustment made by the Commission, namely, the disallowance of depreciation on plant financed by deferred taxes, constituted a partial flow-through of deferred taxes. Having found that the Commission's adjustment constituted a partial flow-through, the Maine Court simply applied its holding in the *New England* case that any such adjustment constitutes arbitrary action and an abuse of discretion under state public utility law.

The Petition asks this Court to address a subsidiary issue in a rate case in which the ultimate issue was: What are just and reasonable rates for Central Maine under the Maine public utility law? The Petition asks this Court to consider whether or not the disallowance of depreciation on plant financed by deferred taxes is a partial flow-through in a context other than that in which such issues are directly and clearly raised as federal questions ripe for adjudication—*i.e.*, the confrontation between a taxpayer and the Internal Revenue Service. The adjustment made by the Maine Commission is one of many adjustments that a public utilities commission could attempt in trying to circumvent the intent of Section 167(*l*). Any ruling by this Court on the failure of the attempt made in this case would have no wide-ranging influence. The only result would be to render an advisory opinion to reinforce what is abundantly clear from the language and purpose of Section 167(*l*) and the Regulations and the Rulings of the Internal Revenue Service pertaining thereto: any attempt to disallow depreciation on plant financed by deferred taxes constitutes a partial flow-through of the benefits of accelerated depreciation and thus contravenes the strictures of Section 167(*l*).

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition of the Maine Public Utilities Commission for a writ of *certiorari* should be denied.

DATED: December 5, 1979

Respectfully submitted,

GERALD M. AMERO

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Allen, Smith & Lancaster
One Monument Square
Portland, Maine 04101

SEWARD B. BREWSTER

Edison Drive
Augusta, Maine 04336

Attorneys for Central
Maine Power Company,
Respondent

APPENDIX

APPENDIX A

STATE OF MAINE

SUPREME JUDICIAL COURT

LAW COURT DOCKET NO. KEN-78-52

CENTRAL MAINE POWER COMPANY, *Plaintiff,*

VS.

PUBLIC UTILITIES COMMISSION,
Et als, *Defendant.*

Motion Requesting Certificate From The Law Court That A Federal Question Was Decided In Regard To The Provisions Of 26 U.S.C. § 167(*l*)

NOW COMES the Public Utilities Commission and moves as follows:

WHEREAS, The Maine Supreme Judicial Court sitting as the Law Court issued its decision in *Central Maine Power Company vs. Public Utilities Commission, et als.,* Docket Number Ken-78-52 on August 6, 1979; and

WHEREAS, The Law Court sustained the appeal of Central Maine Power Company in regard to the Commission's disallowance for ratemaking purposes of depreciation expense on plant financed by deferred taxes; and

WHEREAS, The Law Court, in sustaining the appeal, ruled that the Commission's adjustment violated the normalization provisions of 26 U.S.C. §167(*l*); and

WHEREAS, The Public Utilities Commission intends to petition for certiorari on that determination to the Supreme Court of the United States by invoking jurisdiction under 26 U.S.C. §1257(3) on the grounds that a substantial federal question was decided by the Law Court; and

WHEREAS, The Public Utilities Commission believes that a Certificate from this Court stating that a federal question was decided would greatly aid the Justices of the United States Supreme Court in determining whether to grant or deny the Petition for Certiorari;

NOW THEREFORE, The applicant Public Utilities Commission respectfully requests this Court to issue a Certificate stating that the Law Court held, in *Central Maine Power vs. Public Utilities Commission,* Docket Number Ken-78-52, that as a matter of federal law the Commission's disallowance of depreciation expense on plant financed by deferred taxes violated the normalization provisions of 26 U.S.C. §167(*l*) and that this decision was necessary to the judgement [sic] rendered.

Dated at Augusta, Maine this 27th day of September, A.D., 1979.

Respectfully submitted,

/s/ HORACE S. LIBBY
Horace S. Libby
Attorney

/s/ STEPHEN A. JOHNSON
Stephen A. Johnson
Attorney

NOTICE OF HEARING

To All Counsel:

Please be advised that counsel for the Maine Public Utilities Commission will bring this Motion forward for hearing before the Maine Supreme Judicial Court in Portland, Maine at 10 o'clock in the forenoon on Monday October 1, 1979.

/s/ HORACE S. LIBBY
Horace S. Libby
Attorney

/s/ STEPHEN A. JOHNSON
Stephen A. Johnson
Attorney

CERTIFICATE OF SERVICE

I hereby certify that I have on this date served a copy of this motion by delivering it in hand or by mailing it, postage prepaid, first class, United States mail to each of the following;

Gerald M. Amero, Esquire, and James E. Purcell, Esquire, Pierce, Atwood, Scribner, Allen, Smith & Lancaster, One Monument Square, Portland, Maine 04111; Seward B. Brewster, Esquire, Central Maine Power Company, Edison Drive, Augusta, Maine 04336, Counsel for Central Maine Power Company; Mark L. Haley, Esquire, Fitzergald, Donovan, Conley & Day, 746 High Street, Bath, Maine 04530, Counsel for Maine Oil Dealers Association and 10 individual complainants; Thomas Schulten, Esquire, Perkins, Thompson, Hinckley & Keddy, One Canal Plaza, P.O. Box 426, Portland, Maine 04112; Margaret W. Dobbins, Esquire, St. Regis Paper Company, 150 East 42nd Street, New York, New York 10017, Counsel for St. Regis Paper Company; Paul A. Fritzche, Esquire, Pine Tree Legal Association, Inc., 277 Lisbon Street, Lewiston, Maine 04240; V. Louise McCarren, Esquire, P.O. Box 514, Burlington, Vermont 05401, Counsel for the Consumer Action Coalition, Maine Citizens Committee for Utility Rate Reform and Bruce M. Reeves; Virginia E. Davis, Esquire, Natural Resourses [sic] Council, 335 Water Street, Augusta, Maine 04330, Counsel for the Natural Resourses [sic] Council of Maine.

Dated at Augusta, Maine this 27th day of September, A.D., 1979.

/s/ HORACE S. LIBBY, ESQUIRE
Horace S. Libby, Esquire
Public Utilities Commission
State House
Augusta, Maine 04333

The Maine Supreme Judicial Court sitting as the Law Court hereby certifies to the Supreme Court of the United States that in the appeal to this Court entitled *Central Maine Power Company vs. Public Utilities Commission, et als,* Law Court Docket Number Ken-78-52, there was properly presented and necessarily passed upon a substantial federal question, viz.: The Appellant, Central Maine Power Company, argued on appeal that a ratemaking adjustment ordered by the Maine Public Utilities Commission, disallowing as a ratemaking expense depreciation expense on plant financed by deferred taxes, violated the normalization provisions of I.R.C. §167(*l*), This Court sustained Central Maine Power Company's appeal on that point holding that the Commission's adjustment did violate the normalization requirements of I.R.C. §167(*l*), and that this decision was necessary to the judgement [sic] rendered.

Dated:

Charles A. Pomeroy
Acting Chief Justice

Edward S. Godfry [sic]
Associate Justice

Sidney W. Wernick
Associate Justice

David A. Nichols
Associate Justice

James P. Archibald
Associate Justice

APPENDIX B

STATE OF MAINE

SUPREME JUDICIAL COURT
SITTING AS THE LAW COURT

LAW COURT DOCKET
NO. Ken-78-52

CENTRAL MAINE POWER COMPANY,
Plaintiff

v.

PUBLIC UTILITIES COMMISSION, ET AL, *Defendants*

ORDER

On the Motion of the Public Utilities Commission representing that it *"intends to petition for certiorari. . .to the Supreme Court of the United States on the decision of this Court in Central Maine Power Co. v. Public Utilities Commission, et als., Docket Number Ken-78-52"* (Aug. 6, 1979), Me., A.2d. That decision, the motion states "sustained the appeal of Central Maine Power Company in regard to the Commission's disallowance for rate-making purposes of depreciation expense on plant financed by deferred taxes". As an aid in the Commission's Petition for Certiorari a Certificate[1] by this Court clarifying the ground of our decision is requested.

Upon consideration of said motion, the Court concludes:

(1) The Court's opinion speaks for itself, without need for clarification. In setting forth the ground of decision, more particularly the opinion states the following:

> *Our extensive review of the Legislative history of §167(1)* in New England Telephone need not be reiterated here, except to note again our conclusion that

[1] *See,* Stern & Gressman, *Supreme Court Practice,* 5th ed., §3.29 (1978).

> Congress intended "to create a deferred tax reserve which [*would provide*] interest free capital to the utility. . .for plant expansion. . .[Me., 390 A.2d 8, at 18]".
>
> *If the action here taken by the Commission constitutes a flow-through of deferred taxes, it would, of course, deplete the source of interest-free capital Congress sought to insure by enacting* §167(1), *and would thus be inconsistent with national economic policy. Simultaneously, it would place Central Maine Power in jeopardy of losing its right to take accelerated depreciation for federal tax purposes, and therefore constitute* "an arbitarary exercise of the Commission's power and. . .an abuse of its discretion" *prohibited by state law. New England Telephone, supra, at 23.*
>
> • • •
>
> *Congress forbade different methods of depreciation for tax and ratemaking purposes in order to provide interest-free investment capital for utility expansion. Regulation which results in the* "loan" being extended (by virtue of accelerated depreciation) but also in the utility being forced to divert a portion of it to other uses as income (by virtue of it being denied as an expense) does not comport with Congressional intent. The result must surely be denial of the "loan" *i.e., the loss of the right to accelerated depreciation.*
>
> *As we observed in New England Telephone, normalization of a utility's regulated books of account does not meet the* §167(1) requirement of normalization if these books may be disregarded by the Commission in setting rates. Where the Commission set rates reflecting a lower depreciation expense that it permits to be taken for tax purposes, a partial flow-through results (whether the Commission wishes to

thus characterize it or not) in the form of lower rates. The utility thus loses, as a direct consequence, the full benefit of the deferred taxes it is allowed, and is further placed in jeopardy of losing entirely its right to take accelerated depreciation.

Central Maine Power Co., supra, slip. op. at 35-36, 48-49.

(2) The Court's decision being thus grounded, the dispute between the parties is really one of characterizing the decision for purposes of determining whether it meets the jurisdictional requirements of the Supreme Court of the United States for the granting of certiorari under 28 U.S.C. §1257;[2]

(3) That determination is for the Supreme Court of the United States under the jurisdictional principles laid out in the statute, as that Court interprets them. It would be inappropriate at this time for this Court to make any characterizing statement.

It is therefore ORDERED that the Motion of the Public Utilities Commission for this Court's Certificate be DENIED.

Dated: October 12, 1979

For the Court:

/s/ CHARLES A. POMEROY
Acting Chief Justice,
pursant to 4 M.R.S.A. §1

All Justices concurring.

McKusick, C.J., and Glassman, J., did not sit.

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[2] *See*, Stern & Gressman, *supra* at §3.32.

APPENDIX C

PRIVATE LETTER RULING 7836038

INTERNAL REVENUE SERVICE DEPARTMENT OF THE TREASURY

Index Number 0167.23-00

Washington, DC 20224

Mr. Robert Dalenberg
Vice-President & General Counsel
Pacific Telephone & Telegraph
Company
140 New Montgomery Street
San Francisco, California 94105

Date: 8 June 1978

Taxpayer—Pacific Telephone & Telegraph Co.*

State—California

Commission—California Public Utility Commission

Parent—American Telephone & Telegraph Co.

Representative—Caplin & Drysdale

Decision X—87838, September 13, 1977

Dear Mr. Dalenberg:

This replies to your ruling request dated September 29, 1977, as supplemented, the latest being dated May 3, 1978, and filed on your behalf by your representatives concerning your company (taxpayer).

You request a ruling that should Decision No. X of the Commission, dated September 13, 1977, become final, will the taxpayer remain eligible for: 1) accelerated depreciation under section 167(*l*) of the Internal Revenue Code; 2) depreciation based on Class Lives Asset Depreciation

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* The comparable ruling issued to General Telephone Company of California is printed herein as Appendix D, infra, pp. .

Range (CLADR) system for post-1970 public utility property; 3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and 4) the investment tax credit?

Taxpayer is a state corporation and is a subsidiary of its parent, which has its principal place of business at 195 Broadway, New York, New York 10007. Taxpayer is subject to regulation by the Commission with respect to its intrastate rates and services. It is a member of a group of affiliated corporations which files consolidated Federal income tax returns under section 1501 of the Code.

By letter dated December 22, 1977, you have formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. Based on your request, we are replying to the first three issues in this ruling letter and will reply to the investment tax credit issues at a later date.

Several state utilities, taxpayer not being one of them, elected accelerated depreciation in the 1950's and chose to establish a reserve on their books of account and for ratemaking purposes for the deferred taxes. This was a normalization method of accounting.

In 1960 the Commission determined that the flow-through method of accounting was to be used in setting rates for utilities using accelerated depreciation for tax purposes. Taxpayer did not elect the accelerated method of depreciation, but chose to remain on the straight line method for tax purposes (until 1970) and in computing depreciation expense in its regulated books of account. Thus, taxpayer used a straight line method of depreciation for both its regulated books of account and for tax purposes for its pre-1970 public utility property.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 public utility property. Pursuant to section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations, the taxpayer has normalized, based on

straight line depreciation, the difference between the longer book lives (to compute depreciation for book purposes) and the shorter CL system lives (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

Pursuant to the Tax Reform Act of 1969, the taxpayer made a timely election to use accelerated depreciation to compute depreciation expense for determining its Federal income tax, beginning with its 1970 tax return and used the normalization method of accounting. Therefore, taxpayer in using an accelerated method of depreciation with respect to its post-1969 public utility property. As taxpayer was using the straight line method of depreciation, as provided under section 167(*l*)(1)(A) of the Code, for tax purposes on August 1, 1969, it was not eligible to use the flow-through method of accounting.

Taxpayer has made a timely election to use the CLADR system for its post-1970 public utility property. Pursuant to section 1.167(a)-11(b)(6)(ii) of the regulations, the taxpayer has normalized the difference between the book lives (to compute depreciation for book purposes) and the power limit of the appropriate asset guideline range (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

The Commission issued a decision on November 6, 1968, concerning taxpayer, establishing rates by reducing taxpayer's tax expense for the test year 1967 as though it had used accelerated depreciation on its 1967 tax return. By computing accelerated depreciation with flow-through, the Commission gave the ratepayers the benefit of a tax deferral which the taxpayer did not actually realize. With the taxpayer's announced use of accelerated depreciation the

Commission issued an interim decision on November 24, 1970, holding that taxpayer's rates would be established to reflect its use of accelerated depreciation and the normalization method of accounting. On June 22, 1971, the Commission granted a rate increase to taxpayer based on the interim decision.

On November 26, 1971, the state Supreme Court annulled the interim decision of November 24, 1970, holding that the Commission had erred in failing to consider lawful alternatives to normalization. The court ruled that imputed accelerated depreciation with flow-through was a lawful alternative, but remanded to the Commission for consideration of all alternatives, including normalization and any compromise between normalization and imputed accelerated depreciation with flow-through. The court then annulled the Commission's June 22, 1971 decision and ordered the Commission to reinstate the rates established in the 1968 decision. On July 23, 1974, the Commission issued a decision granting taxpayer a rate increase based on accelerated depreciation with normalization. The Commission adopted normalization to preserve the taxpayer's eligibility for accelerated depreciation.

On December 12, 1975, the court annulled that part of the Commission's 1974 order relating to the treatment of tax expense, resulting from the use of accelerated depreciation, principally because the court disagred with the Commission's conclusion that it had no regulatory authority to consider alternate methods of treating the accelerated depreciation. The court remanded for further proceeding relating to tax expense.

Following additional hearings, the Commission issued Decision X on September 13, 1977. This decision covers the tax issues in three separate rate cases using test periods for: 1) calendar year 1973; 2) fiscal year 7/1/74-6/30/75 and; 3) fiscal year 7/1/75-6/30/76. The Commission ordered the taxpayer to make refunds and annual reductions in rates with respect to these cases.

It seems the Commission had the view that full flow-through of the tax deferral resulting from using accelerated depreciation was the proper and best ratemaking method, but could not consider it as the taxpayer was not eligible for this method of accounting, since taxpayer was using straight line depreciation on August 1, 1969.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed an "average annual adjustment method." In its presentation of this method, the Commission has attempted to take into account section 1.167(*l*)-1(h)(6) of the regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes.

Decision No. X states that the theory of the method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjusted for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses the taxpayer's actual reserve for deferred taxes for the years 1973, 1974 and 1975, and estimated plant additions for the succeeding three years of each test year and computed the estimated reserve for deferred taxes for these years. The simple average of the average annual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property for the four year period was deducted from the rate base, that was adjusted for the test year depreciation reserve, but not for the additional estimated depreciation reserve for the succeeding three years.

As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this amount from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income was then substituted in the cost of service for the larger test year net operating income figure and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the larger test year tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The Commission believes the taxes set aside in the deferred tax reserve shall never be paid and amounts to a tax savings rather than a tax deferral. The depreciation expense, included in the cost of service, was left undisturbed.

The Commission believes the normalization method of accounting does not approach the only sensible and realistic method of setting rates, that is, using the actual tax expense as the cost of service tax expense. It believes their annual average adjustment adopted in its Decision No. X "is a more equitable and realistic method of normalization than the other proposals and the best available now."

Decision No. X states that the actual Federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it and cites an exhibit submitted by the taxpayer in a rate case. It believes that the Code or regulations thereunder do not discuss the estimating process and believes that this method uses the same time period for estimating the reserve for deferred taxes and the tax expense for establishing cost of service for ratemaking purposes; and that section 1.167(*l*)-1(h)(6) of the regulations is satisfied and eligibility is maintained for

accelerated depreciation, CLADR system and the CL system.

In reviewing the taxpayer's record in the proceedings, it came to the attention of the Commission that for the 1968 and 1969 vintage plant additions no accelerated depreciation was ever reflected in taxpayer's rates. In a previous application of taxpayer, imputed flow-through was proposed for the 1968 and 1969 vintage accounts. Decision No. X adopted this imputed flow-through for these years and used it to determine tax expense in each of the three taxpayer's test year cost of services for ratemaking purposes to compute the reduction in rates and the amount of the refund.

The taxpayer became concerned when the Commission's Decision No. X was issued and therefore requested the present ruling to determine whether the decision would impair its eligibility for accelerated depreciation, use of CLADR system under section 1.167(a)-11 of the regulations and the CL system under section 1.167(a)-12. If the decision becomes final and is inconsistent with the Code and regulations thereunder, taxpayer stated it will have enormous Federal tax obligations for both past and future years. The request for this ruling is the result of the Commission's decision.

The taxpayer states it is following the normalization method of accounting in regard to accelerated depreciation under section 167(*l*) of the Code and adhering to the normalization of tax deferrals resulting from the use of shorter lives for tax purposes than are used for regulatory purposes to comply with section 1.167(a)-11(b)(6)(ii) of the regulations for post-1970 public utility property CLADR system and section 1.167(a)-12(a)(4)(iii) for pre-1971 public utility property CL system.

It is the taxpayer's belief that the average annual adjustment method is the same as the method proposed by the Commission's staff several years ago and rejected by the

Commission as being inconsistent with section 167(*l*) of the Code and regulations thereunder. The taxpayer states that the simple average of the reserve for deferred taxes that is excluded from the rate base is greater than the amount of the reserve for deferred taxes excluded from the test year rate base. Therefore, the exclusion of a larger deferred tax reserve covering a different time period than the time period used in determining tax expense for cost of service purposes is precisely what section 1.167(*l*)-1(h)(6) of the regulations prohibits.

The taxpayer further states that when a computation is made of net revenue reduction, it has a bearing on tax expense because of the necessary mathematical relationship between after-tax net revenues and Federal income taxes. The taxpayer believes the Commission's computation is not how the tax expense under section 1.167(*l*)-1(h)(6)(i) of the regulations should be computed, otherwise this section of the regulations would have no meaning as far as the amount of the reserve for deferred taxes to be deducted from the rate base is concerned. The taxpayer believes the tax expense as computed under the average annual adjustment method does not represent actual or a proper estimated tax expense for the test year, any future year, or any average of these years.

The taxpayer is also concerned about the Commission's use of the actual reserve for deferred taxes being used for the calendar years 1973, 1974 and 1975, while using estimated figures for all other cost of service items, including tax expense. The deferred tax reserve figures for each of the test years were substantially higher than the original estimated figures, as more property was placed in service than originally estimated.

Should the Commission amend its decision to eliminate the four-year forward averaging of the reserve for deferred taxes, the taxpayer states the deferred portion of normalized tax expense included in the cost of service for each test

year would still be equal to the lower estimated figure, while the deferred portion of the normalized tax expense excluded from the rate base would be equal to the higher actual figure. Therefore, the taxpayer believes the amount credited to the reserve and excluded from the rate base should be based on the deferred portion of the tax expense as stated under sections 1.167(*l*)-1(h)(1)(i) and (iii) of the regulations. The taxpayer further states that if the larger actual amount of the reserve is excluded from the rate base then the actual tax expense must be included in the cost of service for ratemaking purposes, otherwise the exclusion of the larger actual amount of the reserve for deferred taxes, without the use of the actual tax expense, would be in violation of section 1.167(*l*)-1(h)(6).

In regard to the question of being eligible for the continued use of accelerated method of depreciation for its post-1969 public utility property when the Commission has ordered imputed flow-through treatment with respect to the taxpayer's 1968 and 1969 vintage accounts, taxpayer states that it computes depreciation allowance for its 1968 and 1969 vintage accounts for both its regulated books of account and tax purposes on the straight line method in accordance with section 167(*l*)(1)(A) of the Code. Also, the imputed flow-through method of accounting for the 1968 and 1969 vintage accounts does not prevent the use of the accelerated methods of depreciation for its post-1969 public utility property. The taxpayer cites section 1.167(*l*)-1(d)(2)(ii) of the regulations, and believes that the phrase, "with respect to the property" means the normalization requirements with respect to the property on which accelerated depreciation is claimed. The taxpayer believes the normalization method of accounting need not be followed for all property as a condition to using accelerated depreciation for post-1969 public utility property.

In regard to the question of being eligible to continue the use of the CL system for pre-1971 property, the taxpayer states the Commission's treatment of the 1968 and 1969

vintage accounts relates only to accelerated depreciation and does not reflect any adjustment of the shorter lives for the property under the CL system than are being used in computing tax expense and depreciation expense in the cost of service for ratemaking purposes. The taxpayer therefore believes the Commission's imputed flow-through of accelerated depreciation for the 1968 and 1969 vintage accounts does not impair its eligibility to use the CL system with respect to these vintage accounts.

Section 167(*l*)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (*l*) method or; (ii) the applicable 1968 method for such property.

Section 167(*l*)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(*l*)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(*l*)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (*l*) method), to compute its Federal income tax liability and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-11(a)(1) of the regulations provides an optional election of an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970.

Section 1.167(a)-11(b)(6)(ii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating result in its regulated books of account. The normalization method of accounting shall have the same definition as stated in sections 167(*l*)(3)(G) of the Code and 1.167(*l*)-1(h).

Section 1.167(a)-11(b)(6)(iii) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(a)-12(a) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. This applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting

shall have the same definition as stated in section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(*l*)-1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (*l*) method (which includes the straight line method) is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(*l*)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(*l*)-1(d)(2)(ii) of the regulations provides that under section 167(*l*)(2) of the Code, in the case of post-1969 public utility property, the term "reasonable allowance" means a subsection (*l*) method or a method of depreciation otherwise allowable under section 167 if with respect to the property the taxpayer uses a normalization method of regulated accounting.

Section 1.167(*l*)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(*l*)(3)(G) of the Code.

Section 1.167(*l*)-1(h)(2) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(*l*)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (*l*) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public property.

Section 1.167(*l*)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(*l*)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of

any projected increase to be credited or decreased to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of that period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flowing-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(*l*) of the Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1,

1969, then it must shift to the straight line method unless it continues to normalize as to that property.

3. If the taxpayer was taking accelerated depreciation and flowing through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so, unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The question presented whether the taxpayer will remain eligible for: (1) accelerated depreciation under section 167(*l*) of the Code; (2) depreciation based on the CLADR system for post-1970 public utility property; and (3) depreciation based on CL system for pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(*l*)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking pur-

poses was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167(*l*)-1(h)(1)(i) and 1.167(*l*)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property, exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6)(i) of the regulations, described in section 1.167(*l*)-1(h)(6)(ii), and the examples set forth in section 1.167(*l*)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years 1973, 1974 and 1975 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(*l*)-1(h)(1)(i), (iii) and 1.167(*l*)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is absent, the exclusion of the actual reserve will be prohibited by section 1.167(*l*)-1(h)(6)(i).

The election of the CLADR system under section 1.167(a)-11(b)(6)(ii) of the regulations, pertaining to post-1970 public utility property, and the continued elective use of this system are conditioned upon the taxpayer following the normalization method of accounting as provided under section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1

(h)(1)(i). We believe the reserve for deferred taxes that is determined over the test year and the succeeding three year period, and includes the tax deferral as determined under section 1.167(a)-11(b)(6)(iii) that is deducted from the rate base, exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

The election of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system, is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period, that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-11(b)(6)(iii) of the regulations pertaining to the elective use of the CLADR system, and under section 1.167(a)-12(a)(4)(iii) pertaining to the elective use the CL system, will result in the termination of the election of the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

There is a question in regard to the treatment of the Commission's imputed flow-through of the 1968 and 1969 vintage plant additions to determine tax expense for the three test years to establish the cost of service for ratemaking purposes and whether such treatment conflicts with taxpayer's eligibility to use accelerated depreciation and the normalization method of accounting with respect to its post-1969 public utility property. The Tax Reform Act of 1969 recognized such a problem existed. To remedy this trend to accelerated depreciation and flow-through whether

imputed, or otherwise, Congress froze the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(*l*) of the Code. Implementing regulations were published. Regardless of what went on before this date if the public utility used straight line depreciation for its pre-1970 public utility property, it would make a timely election to apply accelerated depreciation to its post-1969 public utility property, provided it uses the normalization method of accounting. The taxpayer in this case made a timely election to apply accelerated depreciation to his post-1969 public utility property in accordance with section 167(*l*)(2)(B) of the Code and section 1.167(*l*)-1 (d)(2)(ii) of the regulations. The continued use of accelerated depreciation is dependent upon the taxpayer following the normalization method of accounting as to its post-1969 public utility property and is not affected by the Commission's use of imputed flow-through as to pre-1970 vintage plant additions.

There also is a question in regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1968 and 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions. The use of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The Commission's use of imputed flow-through for the 1968 and 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

A schedule submitted by the taxpayer, dated March 7, 1978, showed that its depreciation expense, Federal income tax expense (normalized), average rate base and average reserve for deferred taxes increased, along with the addition of plant facilities over a period of 5 years (1973-1977 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the

form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(*l*) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153, it states that taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(*l*)-1(h)(1)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation. Additionally, the Commission's imputed flow-through of the 1968 and 1969 vintage plant

additions will not be cause for the taxpayer being ineligible to use an accelerated method of depreciation along with the proper normalization method of accounting as to its post-1969 public utility property. The taxpayer made a timely election to use an accelerated method of depreciation and the election is applicable only to its post-1969 public utility property.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe that it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount as permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on CLADR system property and the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(*l*)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of both the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1968 and 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii) of the regulations.

Very truly yours,

/s/ GEOFFREY J. TAYLOR
Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch

APPENDIX D

PRIVATE LETTER RULING 7836048

INTERNAL REVENUE SERVICE
Index Number 0167.23-00
Mr. A. M. Hart
General Telephone Company
of California
100 Wilshire Boulevard
Santa Monica, California 90401

Department of the Treasury
Washington, DC 20224

Date: 9 June 1978

Taxpayer—General Telephone Company of California

State—California

Commission—California Public Utility Commission

Parent—General Telephone & Electronics Corporation

Representatives—Covington & Burling

Decision X—87838—September 13, 1977

Dear Mr. Hart:

This replies to a ruling request, dated September 29, 1977, as supplemented, the latest being dated April 21, 1978, filed on your behalf by your representatives.

You request a ruling whether your company (taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(*l*) of the Internal Revenue Code; (2) the Class Life (CL) system with respect to the pre-1971 public utility property (1969 vintage accounts) under section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations; and (3) the investment tax credit if Decision No. X of the Commission, dated September 13, 1977 becomes final?

Taxpayer is a wholly owned subsidiary. The principal offices of its Parent are at One Stamford Forum, Stamford, Connecticut 06940. Taxpayer is principally engaged in the business of providing telephone service to residential, commercial, and industrial customers within the state of its incorporation, and its intrastate rates are regulated by the Commission of that state.

By letter dated January 24, 1978 you stated that you are concerned with a timely response to the issues concerning accelerated depreciation under section 167(*l*) of the Internal Revenue Code of 1954 and the CL system with respect to pre-1971 property. You ask that the ruling request be treated as two separate ones, with the response to the two depreciation issues first, and the response to the investment credit issue at a later date. In compliance with that request, we are ruling on the first two issues in this ruling letter and will reply to the investment tax credit issue at a later date.

In 1960 the Commission determined that the flow-through method of accounting was mandatory for utilities electing accelerated depreciation for tax purposes. The election of accelerated depreciation was left to the utility companies and taxpayer remained on straight line depreciation for tax purposes through 1969.

For its pre-1970 public utility property taxpayer used straight line depreciation for computing both its tax expense and depreciation expense for establishing its cost of service for ratemaking purposes, in its regulated books of account, and for actual tax purposes.

After August 1, 1969, the taxpayer, in accordance with the Tax Reform Act of 1969, made a timely election to use accelerated depreciation for its post-1969 public utility property. It was permitted to do so by the Commission and to normalize the deferred taxes beginning with the year 1970.

The proceedings that resulted in Decision No. X, followed the remand by the State Supreme Court in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680, which annulled that portion of the rate increase granted another public utility and taxpayer, relating to accelerated depreciation and investment tax credit. In the remand of the case the court held that the Commission has the power to implement an alternative method, one that involves an annual adjustment of the tax expense treatment for acceler-

ated depreciation and investment tax credit. The timely election by the taxpayer of accelerated depreciation, commencing with its taxable year 1970, led to the proceedings in which the Commission in its Decision No. X has attempted to comply with the mandate from the court to reach an equitable determination of the election of accelerated depreciation. In its presentation of the "average annual adjustment method," the Commission has attempted to take into account section 1.167(*l*)-1(h)(6) of the Income Tax Regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes. The taxpayer has before the Commission three rate cases using calendar year test periods 1970, 1974 and 1976.

It seems that the Commission viewed the full flow-through as being the proper and best ratemaking method, but since the taxpayer was not using an accelerated method of depreciation on August 1, 1969, flow-through could not be required.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed the "average annual adjustment method."

Decision No. X states that the theory of this method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses actual deferred tax amounts through 1976 and estimated amounts thereafter. This method consists of taking the simple aver-

age of the average annual reserve for deferred tax for both pre-1970 public utility property and post-1969 public utility property for the four year period and deducting this amount from the rate base, adjusted for the test year depreciation reserve, but not for the additional depreciation reserve for the succeeding three years. As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this deferred tax reserve from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income figure was then substituted in the cost of service for the larger net operating income figure of the test year and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the test year's larger tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The depreciation expense, included in the cost of service, was left undisturbed.

Decision No. X states that pertinent sections of the Internal Revenue Code and regulations thereunder do not discuss the estimating process. Apparently, the Commission is of the view the method set forth in its decision uses the same time period for estimating both the reserve for deferred taxes and the tax expense for cost of service for ratemaking purposes; that section 1.167(*l*)-1(h)(6) of the regulations is satisfied; and eligibility for accelerated depreciation is maintained because while the method is different, the principle is identical to the ordinary test year principle. The Commission seems to take the view that the taxes set aside in the reserve for deferred tax account will never be paid and thus will amount to an actual tax savings rather than a tax deferral.

In reviewing the record of the taxpayer's proceedings it came to the attention of the Commission that 1969 vintage plant additions were not previously considered in the ratemaking process. Decision No. X therefore included the 1969 vintage accounts in the ratemaking process by imputing flow-through of accelerated depreciation for that property.

In a previous Commission decision, it imputed flow-through of accelerated depreciation for taxpayer for its 1968 vintage plant using a 1968 test year. In a later decision, the Commission ordered increased rates using the normalization method of accounting for the accelerated depreciation beginning with 1970 vintage plant additions. The 1969 vintage plant additions never were reflected in taxpayer's rates. Imputed accelerated depreciation and flow-through was proposed by the Commission for the 1969 vintage plant additions and adopted in Decision No. X and continued through tests years 1970, 1974 and 1976.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 property for taxable years beginning with the year 1971, and has consistently used the straight line method of depreciation for both book and tax purposes for the 1969 vintage accounts and prior year accounts.

The taxpayer cites sections 1.167(*l*)-1(a)(1) and (2) and 1.167(*l*)-1(h)(6) of the regulations, and states that these regulations mandate synchronization of the reserve for deferred taxes that is deducted from the rate base with the corresponding tax expense that is included in the cost of service. It also states that, in accordance with section 1.167(*l*)-1(a)(1) the reserve for deferred taxes is to be increased only by the excess accelerated depreciation over the depreciation used in computing both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes.

The Commission had stated that based on an exhibit submitted by the taxpayer in a rate case, the actual Federal

tax expense bears no direct relation to the increase in deferred tax reserve but fluctuates independently of it. The taxpayer states that the figures in this exhibit need to be adjusted for straight line depreciation and investment tax credit to portray normalized tax expense. A table was submitted by taxpayer showing that actual increased plant additions resulted in additional revenues, Federal income tax expense, and net operating income over a period of seven years.

The taxpayer believes that since the increased depreciation accruing from the estimated plant additions has not been used to compute the depreciation expense included in the cost of service for ratemaking purposes, the estimated reserve for deferred taxes does not exist and there can be no additional exclusion from the rate base. The taxpayer also states the Commission's average annual adjustment method would require more than a permissible deduction of the reserve for deferred taxes from the rate base and the taxpayer would not be permitted to use an accelerated method of depreciation.

In regard to the election of the CL system, taxpayer states that, in conformity with section 1.167(a)-12(a)(4)(iii) of the regulations, and using straight line depreciation, it has normalized the difference in depreciation between that which is based on the longer lives used for book purposes and that which is based on the shorter CL system lives used to compute depreciation for actual tax purposes.

The taxpayer states it has never used accelerated depreciation for its 1969 vintage plant additions. Thus, the deferred tax reserve required to be flowed-through by the Commission's imputed accelerated method of depreciation does not actually exist on taxpayer's books. Taxpayer states that the flow-through is a purely hypothetical deferred tax reserve that would have developed by reason of the difference between the fictional tax based on accelerated depreciation and the actual amount of tax paid based on straight line depreciation.

The taxpayer has normalized and will continue to normalize all tax deferrals resulting from the election of the CL system.

The taxpayer believes that if a taxpayer who is required to normalize with respect to qualified public utility property fails to normalize, the election to apply class lives shall terminate as of the beginning of the tax year for which the taxpayer fails to normalize. Taxpayer believes that since Decision No. X imputed flow-through with respect to its 1969 vintage plant additions beginning in 1970, it will not be entitled to use class lives for such property for any year.

Section 167(*l*)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (*l*) method or; (ii) the applicable 1968 method for such property.

Section 167 (*l*)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(*l*)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(*l*)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (*l*) method), to compute its Federal income tax liability and to

compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-12(a)(1) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970 and applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property for which no guideline life was prescribed in Rev. Proc. 62-21 shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is, the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting shall have the same definition as stated in section 167(*l*)(3)(G) of the Code and section 1.67(*l*)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(*l*)-1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (1) method (which includes the straight line method) is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting

operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(*l*)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(*l*)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(*l*)(3)(G) of the Code.

Section 1.167(*l*)-1(h)(2)(i) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(*l*)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (*l*) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public utility property.

Section 1.167(*l*)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(*l*)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of the period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flow-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed-through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969 regarding methods of depreciation by enacting 167(*l*) of the

Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.
2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1, 1969, then it must shift to the straight line method unless it continues to normalize as to that property.
3. If the taxpayer was taking accelerated depreciation and flowing-through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permitted it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The questions presented, whether the taxpayer will remain eligible for: 1) accelerated depreciation under section 167(*l*) of the Code and 2) depreciation based on the CL system with respect to the pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(*l*)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking purposes was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167 (*l*)-1(h)(1)(i) and 1.167(*l*)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6)(i) of the regulations, described in section 1.167(*l*)-1(h)(6)(ii), and the examples set forth in section 1.167(*l*)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years through 1976 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(*l*)-1(h)(1)(i), (iii) and 1.167(*l*)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is

absent, the exclusion of the actual reserve will be prohibited by section 1.167(*l*)-1(h)(6)(i).

In regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions, the use of this system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The imputed flow-through of accelerated depreciation for the 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

The election of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to the elective use the CL system will result in the termination of the election of the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

A schedule submitted by taxpayer, dated September 29, 1977, showed that its revenues, Federal income tax expense and net operating income increased, along with the addition of plant facilities, over a period of 7 years (1970-1976 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(*l*) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the Staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153 it states that the taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense, thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(*l*)-1(h)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision No. X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(*l*)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of the CL system at the beginning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL

system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii).

Very truly yours,

/s/ Geoffrey J. Taylor
Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch

Supreme Court, U.S.
FILED
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No. 79-725

In the Supreme Court of the United States

OCTOBER TERM, 1979

THE STATE OF MAINE PUBLIC UTILITIES COMMISSION,
PETITIONER

v.

CENTRAL MAINE POWER COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME JUDICIAL COURT OF THE STATE OF MAINE

MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

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Solicitor General
Washington, D.C. 20530

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MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

This memorandum is filed pursuant to the Court's invitation of February 19, 1980.

QUESTION PRESENTED

Whether the decision below held that the ratemaking order of the State of Maine Public Utilities Commission would have jeopardized respondent's eligibility for accelerated depreciation for federal income

tax purposes under Section 167(*l*) of the Internal Revenue Code of 1954 (26 U.S.C.).

STATEMENT

Respondent is a public utility that has elected for federal income tax purposes to adopt the normalized method of accounting under Section 167(*l*) of the Internal Revenue Code of 1954 (Pet. App. A 45). Under that method of accounting, respondent may compute certain of its depreciation deductions under accelerated methods for tax purposes only if those same depreciation expenses are computed under straight-line methods for ratemaking purposes. Adjustments must be made to a deferred tax reserve account to reflect the differences in the two depreciation computations. See Section 167(*l*)(3)(G).

On January 16, 1978, respondent filed a proposed rate schedule with petitioner, the Maine Public Utilities Commission. Respondent's rate schedule sought approximately $25 million in additional revenues (Pet. App. A 15). After extensive hearings, the Commission adopted a rate schedule which granted respondent approximately a $15.5 million rate increase (Pet. App. A 17). In setting these rates, the Commission determined that respondent should not be recompensed by the ratepayers for all the depreciation expenses it had claimed. Rather, the Commission concluded that depreciation claimed on property financed by respondent's reserve for deferred taxes was not a cost that should be borne by the ratepayers.[1] The Commission premised this adjustment on its view that the reserve constituted capital that respondent's investors had not supplied. As the Commission viewed the matter, neither respondent nor its investors were entitled to recover that capital in the form of depreciation, but the recovery should instead be secured for respondent's ratepayers (Pet. App. A 37-39; Pet. App. B 141-144).

In November 1978, pursuant to the provisions of Me. Rev. Stat. Ann., tit. 35, §§ 303, 305 (1964), respondent sought review of the Commission's decree in the Supreme Judicial Court of the State of Maine (Pet. App. A 17-18). That court upheld respondent with respect to the disallowed depreciation expenses and remanded the case to the Commission for appropriate adjustments. From its examination of the terms of Section 167(*l*) of the Internal Revenue Code of 1954, the accompanying legislative history and Treasury Regulations, and the pertinent private letter rulings of the Internal Revenue Service, the court concluded that the Commission's action departed

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[1] For the test year 1977, respondent's deferred tax reserve was $19,504,000. See Section 167 (*l*)(3)(G). Because the Commission was unable to trace respondent's assets to their respective capital sources, the Commission assumed that a pro rata portion of each depreciable asset had been financed out of this reserve. Accordingly, the Commission multiplied the amount of the reserve by respondent's composite depreciation rate (3.32%) to determine the amount of depreciation attributable to property financed by the reserve. The net effect of this determination was to lower respondent's required revenue needs by approximately $600,000 (Pet. App. A 37-38, 47-48; Pet. App. B 141, 143-144).

from the Internal Revenue Code's requirement of normalization and thereby jeopardized respondent's eligibility to claim accelerated depreciation for federal income tax purposes. In the court's view, the Commission abused the ratemaking discretion conferred upon it by state law in placing respondent in such jeopardy (Pet. App. A 21, 42-56). As the court observed, "A contrary conclusion would ask us to believe that Congress intended the strictures of § 167(*l*) to be merely advisory; that if the State regulatory agencies wished to defy national economic policy they were free to do so" (Pet. App. A 48-49).

DISCUSSION

The decision below correctly held that implementation of the Commission's decision would have jeopardized respondent's eligibility to claim accelerated depreciation for federal tax purposes. Under Maine law, the Commission does not have authority to set rates in such a manner as to "jeopardize" a public utility's right to claim accelerated depreciation for federal income tax purposes. In a similar case, *New England Telephone and Telegraph Co.* v. *Public Utilities*, 390 A. 2d 8, 24 (Me. 1978), the court below had previously held that the Commission had unreasonably exercised its powers and abused the ratemaking discretion conferred upon it when it set rates in such a manner as to create—

> a reasonable likelihood that * * * [a utility] would lose its ability to take accelerated depreciation or, at least be subject to federal action with respect thereto. The effect of the Commission's decree, if sustained by this Court, would be, at least, to place * * * [the utility] in jeopardy of losing its ability to take accelerated depreciation for federal income tax purposes.

In the *New England* case, the Maine court explicitly stated that for state law purposes it was not necessary to determine whether the utility "would lose its right to take accelerated depreciation" if the Commission's rate order were upheld. Rather, the fact that the utility was placed in "jeopardy" of losing that right or might "be subject to federal action with respect thereto" was a sufficient ground upon which to conclude that the Commission's order was beyond the scope of its authority (*ibid.*).

Here, the decision below likewise held that the Commission's rate order would jeopardize respondent's eligibiilty to claim accelerated depreciation or, "at least, [render it] * * * subject to federal action with respect thereto" *New England Telephone and Telegraph Co.* v. *Public Utilities, supra,* 390 A. 2d at 24. See also Pet. App. A 48-49. In so ruling, we submit that the Maine court correctly concluded that the Commission's order would require respondent to violate the conditions under which accelerated depreciation can be claimed for federal tax purposes.

When Congress enacted the normalization requirements of Section 167(*l*), it intended to proscribe certain regulatory practices that effectively passed through to the consumer the full measure of tax sav-

ings that flowed to certain utilities electing to claim accelerated depreciation for federal income tax purposes. See, generally, *FPC* v. *Memphis Light, Gas and Water Division*, 411 U.S. 458 (1973). Congress concluded that the combined effect of accelerated depreciation (leading to higher tax deductions) and flow-through for fixing rates (leading to lower gross revenues and therefore lower taxes) resulted in an unacceptable loss of federal revenues. H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 131-132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 172-175 (1969).

Thus, in Section 167(*l*) of the Code, Congress provided that utilities such as respondent were entitled to accelerated depreciation for tax purposes only if their rates were set under certain "normalized" methods of accounting. Under the normalized methods, rates would generally have to be set as though the utility had not elected accelerated depreciation. The tax savings arising from accelerated depreciation would then be reflected in a deferred tax reserve account. This method was designed to avoid giving the present customers of a utility the full benefit of the tax deferrals attributable to accelerated depreciation and make the deferred taxes available to the utility for investment.

This is not to say that none of the benefits of accelerated depreciation can be passed on to the ratepayers under normalization. Rather, Congress intended that a small portion of those benefits could be passed on to the ratepayers in the form of lower rates. Accordingly, it explicitly permitted the amount

reflected in the deferred tax reserve (or the public utility property acquired with that amount) to be excluded from the rate base upon which a regulatory agency "computes the company's maximum permitted profits" S. Rep. No. 91-552, *supra*, at 173. See Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.), Section 1.167(*l*)-1(h)(6); see *Pacific Telephone and Telegraph Co.* v. *Public Utilities Commission of California*, hearing denied, No. 23746 (Cal. Sup. Ct. July 13, 1978), cert. denied, 439 U.S. 1052 (1978).[2] But as the Committee Reports

[2] Contrary to petitioner's suggestion (Pet. 11), the decision below does not conflict with *Pacific Telephone and Telegraph Co., supra*, where we filed a brief *amicus curiae* urging review by this Court. There, the Supreme Court of California denied hearing of an appeal from a ruling of the California Public Utilities Commission that its rate-making orders preserved the utilities' eligibility for the investment credit and accelerated depreciation under Sections 46(f) and 167(*l*) of the Internal Revenue Code.

Petitioner argues (Pet. 11) that the decision below conflicts with *Pacific Telephone and Telegraph Co.* insofar as the California Commission's order remains undisturbed while "the Maine Commission's judgment has been reversed." Apart from the differences in the methods of accounting employed by the regulatory commissions in the two cases, the standards of review employed by the state courts in the two cases were entirely different. In *Pacific Telephone and Telegraph Co.*, the California Public Utilities Commission was aware of the Internal Revenue Service's rulings that the Commission's order destroyed the utility's eligibility for accelerated depreciation and the investment credit but declined to join the utility in requesting a remand of the case to the Commission, stating that "the ruling adds nothing new to these proceedings" (Decision No. 88972 (June 13, 1978). The

(H.R. Rep. No. 91-413, *supra;* S. Rep. No. 91-552, *supra*) make clear, no other mechanism for passing the benefits of accelerated depreciation on to the ratepayers was to be sanctioned as consistent with the normalization rules. Indeed, any other such mechanism would run directly counter to the statutory purpose of limiting revenue losses attributable to accelerated depreciation.

Here, the rate order entered by the Commission required respondent to eliminate all amounts attributable to the depreciation of assets financed by the deferred tax reserve from its revenue requirements (Pet. App. B 141-144). Accordingly, depreciation expenses taken into account for ratemaking purposes were reduced by approximately $600,000 and that $600,000 reduction in revenue requirements was directly passed through to the ratepayers. It is therefore clear that the Commission's rate order is contrary to Section 167(*l*) and, if permitted to stand, would have jeopardized respondent's eligibility for accelerated depreciation.

Commission presumably disagreed with the Service's ruling on the merits.

Here, on the other hand, the standard of review employed by the Maine Court was whether the Commission's order "jeopardized" respondent's eligibility for accelerated depreciation. In these circumstances, the court was amply justified in concluding that the Internal Revenue Service rulings demonstrated that the Commission's order would have jeopardized petitioner's eligibility for this federal tax benefit. Thus, in addressing the California decision, the Maine court properly found "More significant * * * the initial I.R.S. reaction to that decision" (Pet. App. A 53).

Contrary to the Commission's argument (Pet. 6), its method of computing rates was not simply a permissible adjustment to respondent's basis of its assets.[3] Rather, this change in the treatment of a material item constituted a departure from the normalization method of accounting for ratemaking purposes. Cf. *Korn Industries, Inc.* v. *United States*, 532 F.2d 1352, 1355 (Ct. Cl. 1976); *Witte* v. *Commissioner*, 513 F.2d 391, 393 (D.C. Cir. 1975); Treasury Regulations on Income Tax, Section 1.446-1(e)(2)(i) (26 C.F.R.).

As the court below recognized (Pet. App. A 55), Congress intended that virtually all the benefits of accelerated depreciation must remain with the utilities and not be passed to the ratepayers. See S. Rep. No. 91-552, *supra*, at 174. The Treasury Regu-

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[3] While the Treasury Regulations permit the use of different depreciation bases for computing costs of services and for federal tax purposes when those differences are attributable to a change in the useful life of the property, a change in the taxpayer's unrecovered cost, or certain other adjustments (Treasury Regulations on Income Tax (1954) Code) Section 1.167(*l*)-1(a)(2) (26 C.F.R.); see S. Rep. No. 91-552, *supra* at 174, the Regulations do not permit the elimination of property financed by the deferred tax reserve from the category of property as to which depreciation expense may be claimed. As the Senate Report states, only differences in depreciation methods that arise from the different conventions applicable to financial and tax accounting (for example, the use of "engineering lives" for financial purposes compared to "guideline lives" for tax purposes) are permissible. S. Rep. No. 91-552, *supra*, at 174. The Commission's "adjustment" does not arise from such differing conventions. Rather, it is designed to return to the ratepayers capital which, as a result of the tax deferral available from accelerated depreciation, the federal government had "loaned" to the utility.

lations make clear that unless the full amount of the tax deferral resulting from use of accelerated depreciation is normalized, a utility will be ineligible to claim accelerated depreciation for federal tax purposes. Treasury Regulations on Income Tax (1954 Code) Section 1.167(*l*)-1(h)(2)(ii), Examples (4) and (5).[4] There can be no doubt that the effect of the Commission's order was to pass on a portion of the tax benefit to the ratepayers. Thus, if the order were implemented, respondent would have forfeited its right to claim accelerated depreciation.[5]

Finally, there is no basis for the Commission's assertion (Pet. 12-14) that eligibility for accelerated depreciation depends solely on the utility's keeping

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[4] Examples (4) and (5) of the cited Regulations make clear that a partial flow-through of the benefits of claiming accelerated depreciation for federal tax purposes is prohibited whether the partial flow-through is the result of normalizing only part of the deferred tax reserve or the result of using normalization accounting with respect to only a part of its public utility property. The present case is very similar to Example 5. In that example, an order of a regulatory body requires the utility to use normalization accounting but only with respect to 50 percent of its property. Because the effect of the order is to flow-through a portion of the tax savings resulting from the use of accelerated depreciation, the utility is deemed to have departed from normalization accounting.

[5] There is presently pending before the House Comm. on Ways and Means a bill that would exempt utilities from the present normalization requirements for accounting periods ending prior to March 1, 1980, if the utility used accounting methods prescribed by order of a state or local government, public service or utility commission similar to the methods employed by the California Public Utilities Commission in *Pacfic Telephone and Telegraph Co., supra.* See H.R. 6806, 96th Cong., 2d Sess. (1980).

its books of account in accordance with Section 167 (*l*) and that regulatory treatment in conflict with the federal tax statute will not alone jeopardize eligibility. Section 167(*l*)(3)(G) specifies that the required methods of accounting be used "for ratemaking purposes." Congress therefore plainly intended that the state regulatory agencies must adhere to normalization requirements if utilities are to maintain eligibility for accelerated depreciation. As the Senate Report explained, in terms that explicitly refute the Commission's contention (No. 91-552, *supra*, at 174):

> The committee amendments provide that the requirement of normalizing is not met by simply normalizing the regulated books of account of the utility if these books of account may be ignored by the regulatory agency in setting rates. Under the committee amendments, while the regulated books of account are to be used as the basic source of information, these books are not to control if the current rates of the utility are set by reference to the flow-through method. This is done because the use of flow-through in setting rates would produce the revenue loss the bill seeks to avert.

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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Solicitor General

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